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Eliminating Barriers to International Trade and Investment in Services

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Management Summary

- Trade barriers to services exports more than ever are of critical concern to both U.S. and foreign services companies, a recent Conference Board survey finds.
- However, barriers to international investment in services are emerging as an equally important concern, the survey finds.
- The important role played by investment in the international services market is a factor to be considered in any future round of multilateral trade negotiations.
- There are two directions that executives in the services sector would like their own government negotiators to take in addressing the concerns of services industries with regard to barriers to services trade and investment: to become more knowledgeable about the importance of worldwide and national services trade and investment and the concerns of each of the particular services industries; and/or to permit participation in future negotiations by industry representatives.
- Strongest support is given to using existing, general, multilateral approaches for tackling international trade issues in the services sector; but considerable support is given to using new, industry-specific bilateral approaches as well.

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Issues and Highlights

Services industries involved in international business have been demanding and receiving increasing attention in recent years from both government and business leaders and organizations. Since a GATT (the General Agreement on Tariffs and Trade, see adjacent box) ministerial meeting in November 1982, the United States has strongly urged that trade and investment issues of the services industries be included in any new multilateral negotiations. After much lobbying by the United States and other nations actively engaged in the international services industries, GATT decided at the Punta del Este meeting in Uruguay in September 1986, to include those areas in its next round of negotiations.

The Conference Board has several hundreds of Associate companies active in the services sector. Informal discussions with executives of some of them late in 1985 and early in 1986 indicated differences in views about using the GATT organization to eliminate barriers to their international operations. Therefore, in the Spring of 1986, The Conference Board undertook a survey of 525 associate firms around the world that are active in a variety of services industries. The purpose of the survey was to ascertain the views of business leaders in services firms involved in international business on the use of GATT or some other approach to eliminate international trade and investment barriers in the service sector. Usable responses were received through July 1986. (See Table 1.)

— A total of 525 survey letters were sent. In all, 141 responses (27 percent) were received from 23 countries. Of these firms, 115 had international services operations.

— U.S. firms made up slightly more than half of all the respondents largely because of the preponderant number of U.S. services firms in The Conference Board's Associate list to which the survey was sent.

— A significantly higher proportion of European services firms receiving the survey (51 percent) sent in responses than was the case with other parts of the world.

The distribution of responses by different types of services industries is shown in Table 2.

— The 141 firms responding had 227 distinct international operations.

— Of these, nearly half were in financial services.

— Professional services make up about 10 percent and transportation and shipping services and business services about 8 percent each of all the operations.

— Except for the preponderance of financial services, the survey responses come from a wide variety of international services.

What Is GATT?

The General Agreement on Tariffs and Trade (GATT) was negotiated in 1947 under the auspices of the UN Economic and Social Council, and entered into effect as a separate agreement on January 1, 1948. GATT was meant to be an interim agreement among the contracting parties to permit them to resolve certain trade issues of that time. A more permanent specialized agency attached to the United Nations, the International Trade Organization (ITO), was proposed to become the instrument governing international trade and promoting liberalization of that trade for its members. Although the ITO was negotiated, it was never ratified. This left the interim GATT as the only agreement, and its secretariat as the only capable organization, establishing rules for international trade and supported by most of the major trading nations in the world.

Thus, GATT has emerged both as a set of rules and principles and as a forum for negotiating changes to them or for developing new ones. Its secretariat also provides a framework and machinery for settling trade disputes that arise among the 92 contracting parties. Its main purpose is to foster the liberalization of international free and fair trade in a manner mutually acceptable to its contracting parties and protective of their individual interests in matters of special and temporary concern.

Since its founding GATT has held seven "rounds" of multilateral trade negotiations: Geneva (1947), Annecy (1949), Torquay (1951), Geneva (1956), Geneva—the "Dillon Round" (1959-62), Geneva—the "Kennedy Round" (1963-67), and Geneva—the "Tokyo Round" (1973-79). The first six rounds were mainly concerned with the reduction of tariffs. The seventh, however, was expanded to include negotiations on the elimination of nontariff barriers as well. Codes were developed on such subjects as subsidies and countervailing duties, antidumping measures, import licensing procedures, and government procurement practices. The talks in the Fall of 1986 are preliminary to a proposed new round of multilateral trade negotiations.

Because GATT was originally meant to be an interim organization its structure is limited. Its highest body is the Session of Contracting Parties, a meeting of trade ministers usually held once a year. Between these meetings, a Council of Representatives to GATT meets more frequently to deal with both routine matters and any urgent business that may occur. GATT has a paid staff of about 300, is headed by a Director-General, and is headquartered in Geneva, Switzerland.

Overview of Trade and Investment in Services

The economic significance of the services sector both domestically and internationally has grown steadily in the past two decades. In many developed and some developing countries employment in the services sector has reached substantially more than half of total employment. (See Table 3.) Services as part of gross domestic product (GDP) have also shown important growth in the last 20 years. Both developed and developing countries are included in this growth, although the level of services in the developing countries lags behind that in the developed countries because it started from a lower base 20 years ago. (See Table 4.) Internationally, trade in services (excluding returns from foreign investment) had reached more than 20 percent of merchandise trade by 1980 and has continued to move up.[1]

In the debate on barriers facing firms with international

[1] *U.S. National Study on Trade in Services: A Submission By the United States Government to the-General Agreement on Tariffs and Trade, 1984.* Washington: U.S. Government Printing Office 1984. Other national studies for selected countries available from GATT in Geneva.

Table 1: Geographical Distribution of Survey Responses

Area	Survey letters sent Number	%	Survey Responses Number	%	Response Rate
United States	366	70	74	53	21
Canada	61	12	20	14	33
Europe	72	14	37[a]	26	51
Other	26	5	10[b]	7	39
Total	525	100[c]	141	100	27

[a] Includes Austria, Belgium, Denmark, Federal Republic of Germany, France, Italy, Liechtenstein, Netherlands, Norway, Sweden, Switzerland, United Kingdom

[b] Includes Brazil, Colombia, Indonesia, Japan, Mexico, Philippines, South Africa, Thailand, Trinidad and Tobago.

[c] Details do not add to 100 percent because of rounding.

operations attention has been focused upon *trade* in services. However, international *investment* in the services sector also faces barriers. This report, therefore, also highlights the role of international services investment in the overall debate on problems facing international services. Examples of investment by a service firm overseas include the establishment of a branch bank in Brazil by a foreign banking firm, the construction of a hotel in a resort area by an international hotel chain or tourist organization, the organization of a joint venture accounting firm between an American firm and a local firm to serve local clients in Thailand, and the setting up of a fast-food facility by a foreign-owned restaurant chain.

International investment in the services sector is an important part of total world investment across national borders. The International Trade Administration of the U.S. Department of Commerce, for example, reported that of 362 identified cases of foreign direct investment in the United States in the first three quarters of 1985, 156 (43 percent) were in the services sector.[2] These investments came from 24 countries in Europe, Asia, South America, the Caribbean area and the Middle East and were classified in 27 different service-industry categories.

International Services—Trade, Investment or Both?

Most of the companies responding to The Conference Board's survey operate internationally in one or more of the service sectors in which they operate domestically.

Many responding firms are active in more than one sector of services industries. A U.S. company, for example, reports operations in the entertainment field and in non-bank financial services; a European firm works in ocean freight shipping and in tourism; another European firm provides security services, EDP services, and waste disposal services; a South American company has both banking and travel services; and a Canadian company has trucking subsidiaries and also provides oil field services.

The diversity of business operations combined under the rubric of "services industries" involves a large and diverse number of national and other governmental regulations that create the barriers to international trade and investment in those countries for the regulated industries. The diversity of industries in which international services businesses are involved precludes the easy possibility of services industries organizing a united front on what needs to be done to eliminate the barriers and how best to do it.

Of the total of 141 firms replying, 115 (82 percent) have some international business operations. Among the 24 companies (17 percent) that have no international business, one sector stands out. Eight of the nine utilities companies participating in the survey report they operate entirely within their home countries. They are mainly local gas and electric utilities in the United States, but include one firm each in Canada and in Europe. Of the seven retail firms participating in the survey, three have no international business. The sectors from which the other firms without international business come are financial services, telecommunications, oil-field services, publishing, and education and training services.

International business, whether in goods or services, can usually be undertaken by exporting the product from the country where it is produced (trading) or by establishing facilities outside the firm's home country (investing) from which its products are sold in the country where the facilities are set up, back to the home country, or to third countries. Obstacles to international business operations, therefore, can be in the form of barriers to trade or barriers to investing.

Because the services sector requires that many of its intangible products be consumed at the place of production, the need to establish the company's facilities at the place—making an investment—is especially important to that sector. The United Nations Centre on Transnational Corporations has made a preliminary study of the importance of foreign direct investment (FDI) to international business in the services sector. The study found that investment is more important than

[2] U.S. Department of Commerce, International Trade Administration, "Quarterly Report on Foreign Direct Investment Activity in the United States" for first 3 quarters of 1985. (Available as printouts from the ITA in Washington.)

Table 2: Distribution of Responses by Services Sector (141 Firms with 227 Operations)

Financial Services—total		105
Banking	53	
Non-bank financial services	27	
Insurance	25	
Professional Services - total		22
Engineering	12	
Management consulting	5	
Accounting	4	
Public relations	1	
Transportation and shipping - total		19
Air	7	
Ocean	5	
Truck	2	
Rail	2	
Freight forwarding	2	
Port services	1	
Business Services - total		19
EDP	7	
Leasing	4	
Maintenance (equipment)	3	
Security	2	
Advertising	1	
Manpower	1	
Development of business centers	1	
Telecommunications - total		10
Utilities - total		9
Retail firms - total		7
Tourism - total		7
Other - total		29
Publishing	4	
Education & training	3	
Information services	3	
Entertainment	3	
Franchising	3	
Real estate development	3	
Oil field services	2	
Waste disposal management	2	
Construction	2	
Food Catering	1	
Health Care	1	
Energy Services	1	
Laundry and cleaning services	1	
Total		227

Table 3: Percent of Total Employment in Services for Selected Countries, 1975 and 1984

Developed	*1975*	*1984*
Belgium	66	74[1]
Canada	72	75
Japan	61	66
Sweden	65	72
United Kingdom	65	72
United States	72	76
Developing		
Brazil	47[2]	54[3]
Republic of Korea	35	48

[1] 1983
[2] 1976
[3] 1982

Source: International Labor Organization, *Yearbook of Labor Statistics 1985*

trade and attributed this fact to the intangible nature of many services as compared to tangible manufactured products and natural resource commodities.[1]

The importance of both investing and trading in international services is clearly shown by the responses received to its survey by The Conference Board. Slightly more companies report their international operations are more investing than trading, and more than one-third say their operations are both. (See Table 5.)

If the question is considered by individual services, the investment edge is more pronounced with almost two-thirds of the operations relying mainly on investing or both investing and trading while almost three-fifths are involved in trading or trading and investing.

The importance of international investment is even more clearly seen in a number of specific industries.

— 90 percent of the responding firms in business services are involved in foreign investments;

— 86 percent of the tourism operators are similarly involved;

— three-quarters of the insurance and non-bank financial services firms operate through investments or investments and trade combined.

Only firms in professional services and the transportation and shipping industries give more importance to trading their services than to investing abroad to provide those services. (See Table 6.)

The conclusion emerges from the survey that given the fact that sometimes more services firms with international operations are involved in investment as against trade, there is a need for future multilateral trade negotiations to consider investment barriers as well as trading barriers if obstacles to doing business in foreign markets are to be eliminated for the services industries.

Of the 81 responding firms that listed investing alone or both investing and trading as their way of doing business in foreign markets, 65 give their reasons for choosing investing over trading. Only fourteen cite trade barriers. Of the fourteen, nine are banks, four are insurance companies, and one is a leasing firm. Existing trade barriers are, thus, not a major reason, according to survey participants, for choosing investing as the way to do business for services companies. General barriers applicable to all foreign companies doing business in the country and restrictive regulations on the particular industries mentioned are the usual obstacles reported.

[1] Karl P. Sauvant and Zbigniew Zimny, "FDI and TNCs in services," *The CTC Reporter,* No. 20, Autumn 1985, p. 24.

Table 4: GDP Distribution (in Percent) for Selected Countries, 1965 and 1984[1]

Country	Agriculture		Industry		Services	
	1965	1984	1965	1984	1965	1984
Developed						
Belgium	5	3	41	34	53	64
Canada	5	3	34	24	61	72
Japan	9	3	43	41	48	56
Sweden	6	3	40	31	53	66
United Kingdom	3	2	41	36	56	62
United States	3	2	38	32	59	66
Developing						
Argentina	17	12	42	39	42	50
Brazil	19	13	33	35	48	52
India	47	35	22	27	31	38
Republic of Korea	38	14	25	40	37	47

[1] Details may not add up to 100 percent due to rounding.
Source: *World Development Report 1986*. New York: Published for The World Bank by the Oxford University Press, 1986.

Economic Factors Underlying Investment

Economic factors are more important than the existence of trade barriers in the determination of which path to take—trading, investing or both—in doing business successfully in foreign markets. Among the firms in this survey giving reasons for operating abroad primarily through investments, the ratio of economic factors to existing trade barriers as the primary determinant is almost four to one.

The economic factor most frequently cited is the belief that investing is the most profitable way for the company to sell its service products. Mentioned almost as frequently is the need of most services firms to be close to their customers. This need is especially acute for those firms that sell a service consumed at the point of sale, but is also important to others who believe that being physically close to their customers, either foreign or domestic, is necessary to serve better the customers' product requirements. The managing partner of an international accounting firm sums up this view: "Effective client relations are critical to the success of professional service firms in any market. They require physical proximity, and intimate knowledge of the language, business practices and laws and regulations of the country, and a comprehension of national aspirations." These requirements for successful business, he believes, exist whether or not trading barriers are present.

Other reasons given for operating through investment rather than trading include:

— Location in a foreign market is the best way to provide after sales services and support.

— On site presence makes it easier to understand local markets and their changes.

— International legal and technical communications problems that may exist between the home country and the foreign market are more easily overcome by locating in the foreign country.

— Being physically in the foreign market gives a sense of permanence to the operations of a foreign company, making it seem to be a part of the local community.

Still other factors for deciding to operate through investments are applicable to particular industries. Tourism companies that operate resorts and hotels in foreign markets, for example, often find that investment in those properties is essential if they are to maintain the standards associated with the services they sell around the world. Several banks with worldwide operations report that their success in providing a wide range of financial services requires that they have a presence in all the major financial centers in the world. As the number of these centers grow, so, too, the banks must expand their investments in foreign operations. As one European banker states: "The growth of international money and capital markets, and in particular the spectacular expansion of Eurocurrency markets, made physical presence in the major financial centers a prerequisite if banks are to play a significant role in international financial intermediation."

The important role played by investment in the international services market is a factor to be considered in any future round of multilateral negotiations. GATT is concerned mainly with barriers to *trade* and not with barriers to *investment*. This limi-

Table 5: International Services Operations—Trading or Investing? (in Percent by Area)[1]

Area	Trading	Investing	Both	N.A.
U.S.A.	19	24	28	28
Europe	11	19	59	11
Canada	35	15	20	30
Other	20	20	40	20
Total	19	21	36	23

[1] Details may not add up to 100 percent because of rounding.

Table 6: International Services Operations—Trading or Investing? (in Percent by Industry)[1]

Industry	*Trading*	*Investing*	*Both*	*N.A.*
Financial Services-Total	13	20	50	16
Banking	21	13	51	15
Non-bank financial services	7	26	52	15
Insurance	4	28	48	20
Professional services	45	32	18	5
Transportation & Shipping	37	0	63	0
Business services	5	53	37	5
Telecommunications	20	30	20	30
Utilities	11	0	0	89
Retail stores	29	29	14	29
Tourism	14	0	86	0
Other	17	31	34	17
Total	19	23	42	16

[1] Details may not add up to 100 percent because of rounding

tation on GATT's activities applies to investments in goods production as well as to services. As indicated earlier the United States and several other developed countries have proposed and won support for the inclusion in any new round of multilateral trade negotiations of discussions on ways to remove the barriers to investment as well as to trade.

Barriers to International Services Trade and Investment

Since the launching of GATT in 1948, successful efforts have been made to eliminate many of the tariff and nontariff barriers to trade in goods. But the GATT arrangement is not universal in membership and has many loopholes. Much of the world's trade in goods still lies outside the regulations and codes developed by GATT. More significantly for a world in which the services sector is becoming increasingly important to many countries, GATT so far has excluded from its deliberations the services sector and international investment.

Because services are not yet included in the GATT system, companies in the services sector have not benefited from these efforts. A sample of the kinds of barriers still faced by services industries is given in the box on p. 8.

The outright denial of market access or the restriction on the number of foreign firms in a particular industry, as reported by banking, insurance and professional services firms, are important investment barriers. Government procurement policies that favor local companies, restrictions on advertising, and discriminatory taxation of foreign services are obstacles to trade. Some of the reported barriers (e.g., limitations on remittances abroad) apply to trade and investment in goods as well as services. The wide variety of barriers—more barriers to investment in the case of banking, more barriers to trade in the case of entertainment—and the many countries in which they occur underline the difficulties that must be faced in any international negotiations to eliminate those barriers.

In a report prepared by the U.S. Trade Representative for the U.S. Congress in 1985, 34 countries were reviewed on the subject of international trade barriers. Of the total, 28 countries were found to have some type of barriers against trade in one or more services industries. The industries most affected were telecommunications, motion pictures, insurance, other financial services (including banking), and information services. But a wide range of services industries including trucking, retail stores, professional services, and business services were reported to face some kind of obstacles and discrimination.[4]

A survey of recent government reports and other literature on the services industries reconfirms the following important points about doing business in this sector:

— The growing economic significance domestically and internationally of the services sector especially for the developed countries and especially as a source of jobs.

— A large number of barriers exist to international trade in services that currently are not subject to any international agreement to regulate or reduce such obstacles.

— Trade in international services generates barriers that may differ from and be in addition to the kinds of barriers facing international trade in goods because many services industries require that the service sold be produced at the point of use—unlike trade in goods that permits production in one place and use in another.

— National governments disagree on the appropriate organization as well as the appropriate approach to be used to eliminate these obstacles.

To these results of recent studies and meetings on interna-

[4] Office of the United States Trade Representative, *Annual Report on National Trade Estimates 1985* (as required by Section 303 of the Trade and Tariff Act of 1984) submitted by the U.S. Trade Representative to the Congress of the United States.

Barriers to International Trade and Investment in Selected Services Industries.

Banking:

- Prohibition on entry of foreign banks.
- Restricted number of foreign banks allowed in country.
- Restrictions on number of branches allowed each foreign bank.
- Foreign banks restricted geographically on where they can locate within a country.
- Local equity requirements imposed on foreign banks.
- Restrictions on retail banking operations by foreign banks.
- Restrictions on data processing and transfers.
- Restrictions on operations by foreign banks (e.g. lending ceilings for loans in both foreign and local currencies; no access to rediscount facilities).
- Denial of the national treatment principle generally.

Insurance:

- Outright denial of market access to foreign companies.
- Restricted number of foreign companies allowed in country.
- Equity limits for foreign ownership.
- Prohibition of the sale by foreign companies of certain kinds of insurance (e.g. marine insurance on imports, fire insurance, life insurance).
- Foreign companies allowed to insure only their own citizens or companies owned by their citizens.
- National government monopolies control certain kinds of insurance (e.g. reinsurance) and forbid participation by foreign companies.
- Governments require foreign companies to establish local subsidiaries and not export insurance services from home countries.
- Restrictions on advertising by foreign insurance companies.
- Discriminatory taxation against foreign companies.

Professional Services:

- Outright prohibition against foreign citizens working in some or all professions.
- Discriminatory professional certification rules and procedures.
- Difficulties in obtaining work visas and permits.
- Restrictions on the transfer of professional publications, training materials and software.
- Restrictions on international electronic data transfers.
- Inadequate protection of intellectual property.
- Government procurement policies for services that emphasize "Buy National."
- Restrictions on international payments and remittances.
- Government export subsidies in the engineering/architectural/construction industries.

Telecommunication and Informatics:

- Restrictions on international electronic data transmission.
- Market quotas set for foreign equipment or outright prohibition of its use.
- Standards set up to exclude foreign equipment.
- Discriminating taxes and tariffs to favor local firms.
- Requirements that all firms process data locally.
- Restrictions on the provision of enhanced services by foreign companies.
- Government procurement favors local companies.

Entertainment:

- Screen time quotas for local and foreign theatrical and TV films.
- Foreign films must share theatre bills with local films.
- A fixed percentage of the box office receipts must go to the local films.
- Royalties are set by local committees.
- Film prints must be locally made.
- Dubbing of foreign films must be done locally.
- Import quotas are used for numbers of foreign theatrical and TV films.
- Discriminatory taxation against foreign films.
- Foreign companies not allowed to set up own film distribution offices.
- Foreign companies pay high fees to local film organizations that control import licenses.
- Government subsidies to local film producers.
- Government requires foreign film companies to underwrite local film industry through subsidies and interest-free loans.
- Restrictions on currency remittances.
- Pirating of foreign films.

Sources: The Conference Board's survey responses; Office of The United States Trade Representative, *Annual Report on National Trade Estimates 1985.*

tional services trade, this Conference Board report adds another:

— *The services industries themselves do not agree on the appropriate approach and organization to best resolve the issues of concern to them in conducting their international business.*

Indeed, there is no "services sector viewpoint" on most issues involved in international services trade and investment. Viewpoints may vary by industry and, sometimes, by firms within the same industry. Among the retail firms participating in The Conference Board's survey, for example, three are U.S. companies in the retail food business. Two of the firms believe steps should be taken to eliminate barriers to their business outside the United States, while the third says international barriers have "not been a problem and the current environment is fine."

Comments on specific barriers also reveal substantive differences of view among services industries and individual firms. Several survey respondents point out that because the service often has to be produced on the spot where it is used, professional and skilled workers who provide the service must be able to move across national borders to the site where the service is to be provided. Many countries, however, have restrictions on the movement and employment of foreign labor at all levels of skill. This is an important barrier to competition abroad in their business, according to several services executives, and must be included in any negotiations at GATT or elsewhere to eliminate trade barriers. Among the respondents to this survey calling for such inclusion are a U.S. accounting firm, a large U.S. bank, a European retail company, and a Canadian company that provides engineering services to the petroleum industry.

In contrast to the last, a U.S. engineering and construction company recognizes the issue but does not believe it should become part of new multilateral negotiations on international trade issues. This view was supported by the International Engineering and Construction Industries Council (IECIC) in a statement issued on March 20, 1986.

The disagreements among services firms on the issues and problems extend to where the negotiations should be undertaken to eliminate barriers to the services trade. Of the 141 services companies and conglomerates with services units that responded to The Conference Board's survey, 57 (40 percent) report they favor working through an expanded existing multilateral general trade organization, such as GATT, as the best means to eliminate international barriers to trade and investment in their own industry and for their own firms. Almost as large a number (48 firms, 34 percent) favor using bilateral agreements covering a single or related group of services industries as the best means for their industries to remove trade and investment obstacles. Several give equal emphasis to both approaches—the general multilateral *and* the industry-specific bilateral.

The responses cover a wide range of views. At one end is a Canadian banker who writes, "There are no significant barriers to trade in our fields," and concludes, therefore, that none of the alternative approaches to eliminating trade and investment barriers is needed. A U.S. insurance executive, in contrast, calls for using all available alternatives and writes: "Introduction of services in the GATT is clearly important. I would not mind seeing a new multilateral organization to develop general principles on international trade and investment for the services industries. An industry-specific multilateral organization dealing with barriers unique to a named service industry, i.e. insurance, could be useful. Bilateral agreements covering all services or a single or related group of services could also be useful."

Alternative Approaches to Eliminating Barriers to Trade and Investment in Services

Initial efforts to develop rules and guidelines for the elimination of barriers to international trade and investment in services have begun within the GATT framework for multilateral trade negotiations. Proposals to include these matters on the agenda for the next round of GATT negotiations have been made by the United States and have won support from a majority of GATT's members. Yet, an important minority group of GATT members, led by Brazil and India, has opposed the expansion of GATT's authority into these nontraditional areas at this time. They believe GATT should limit itself to its original sphere of interest—trade in goods—at least until the barriers in that area have been eliminated and GATT has given more attention to the concerns of the interests of the developing nations which, they assert, have been neglected. A compromise of these two views was reached at the GATT meeting in the Fall of 1986, to allow services and investment to be considered in future GATT negotiations.

GATT is by no means the only governmental agreement governing international trade. There are a large number of binational, regional and sectoral arrangements applicable to trade in goods for particular geographical areas or for particular industrial sectors. Some of these have been made within the GATT framework, but others lie totally outside the terms of GATT.

Possible Approaches

As efforts are undertaken to bring some kind of order and to eliminate the obstacles to international trade in services alternative approaches to those goals are available. The Conference Board's survey asked the respondents to choose among five alternative approaches to eliminating obstacles to trade and investment for their own industries and firms:

(1) to work through an *expanded, existing multilateral trade organization,* such as GATT;

(2) to create a *new multilateral organization* to develop general principles on international trade and investment for the services industries exclusively;

(3) to establish *several multilateral organizations* each dealing with a single or related group of services industries, such as insurance, tourism or telecommunications;

(4) to negotiate *bilateral agreements* on a country-by-country basis on general trade and investment principles *covering all services industries;*

(5) to negotiate *bilateral agreements* covering a single *or related group of service industries.*

Although the first and last alternatives received the greatest support from survey participants, the replies are widely distributed among all five approaches. Summaries of the responses by geographic area and industry sector are in Tables 7 and 8.

— Working through an existing general multilateral organization received the most support from companies when considered by area with European firms leading the support.

— Likewise, this approach received the most support when responses were classified by industry with especially strong support given by companies in the business services.

— Establishing a new general multilateral organization received the least support.

— An industry-specific bilateral approach had the second strongest support led by companies in the transportation and shipping field.

A few respondents suggested approaches totally outside the scope of these five alternatives. Bankers in the United States and Europe, a European insurance executive, and a U.S. publishing executive all proposed keeping governments entirely out of negotiations to end trade barriers in the services. Let private representatives of the sectors undertake the negotiations, they suggest, and bring governments in at the appropriate time after agreements are worked out by the private-sector representatives. While such an approach may be appealing to some business leaders, it is seriously unrealistic in one important aspect: Most obstacles to international trade in services (e.g., restrictions on establishment, discriminatory taxation against foreign businesses and other discriminatory regula-

Table 7: Negotiating Alternatives to Eliminating Barriers to International Services Trade and Investment (in Percent by Area)[1]

Area	Existing General Multilateral	Industry-Specific Bilateral	Alternative Approaches[2]: Industry-Specific Multilateral	Alternative Approaches[2]: General Bilateral	Alternative Approaches[2]: New General Multilateral
U.S.A.	31	30	19	18	11
Europe	65	32	14	0	5
Canada	35	45	0	10	10
Other	30	50	20	0	10
All Areas	40	34	15	11	9

[1] Total may equal more than 100 percent because of multiple responses.
[2] See text for more specific description.

Table 8: Negotiating Alternatives to Eliminating Barriers to International Services Trade and Investment (in Percent by Industry)[1]

Industry	Existing General Multilateral	Alternative Approaches[2]: Industry-Specific Bilateral	Alternative Approaches[2]: Industry-Specific Multilateral	Alternative Approaches[2]: General Bilateral	Alternative Approaches[2]: New General Multilateral
Financial Services - total	51	32	11	10	7
Banking	55	36	9	4	2
Non-bank financial services	56	30	7	15	7
Insurance	40	28	20	16	16
Professional services	55	27	14	18	14
Transportation and shipping	58	68	37	16	16
Business services	79	37	5	26	26
Telecommunications	70	20	0	10	10
Utilities	11	0	0	0	11
Retail stores	29	14	14	0	14
Tourism	57	57	43	29	14
Other	31	55	21	14	7
All Industries	51	37	15	13	11

[1] Total may equal more than 100 percent because of multiple responses.
[2] See text for more specific description.

tions, limitations on the movement of persons) are the result of government laws and regulations. Removal of these obstacles requires action by governments.

A United States insurance executive also denies the usefulness of any of the five suggested alternative approaches and argues instead for no changes to be made in the current environment for doing business internationally in the services sector. The laws and regulations affecting his industry, he points out, differ in every country, but his firm has adjusted to them and has learned to live with them. At this time he does not want to be faced with new internationally-negotiated regulations that would disturb the current equilibrium that his firm has achieved in its international operations.

Most of the remaining participants in the survey indicate a choice of one of the five approaches as the best from the point of view of their firm and industry. For more than one-quarter of the respondents, however, two or more of the suggested approaches are equally important and they urge simultaneous efforts on those plural approaches. The stated advantages expected of general-specific, multilateral-bilateral,

and existing or new approaches are summarized in the box on p. 12.

A New Multilateral Organization for Services

Setting up a new multilateral organization to deal exclusively with international trade and investment in services draws the least support among the survey's participants. Those arguing in favor of this approach believe that existing trade organizations are not set up to handle the problems of emerging and expanding services industries, such as informatics and international health care. These services were minor players in international trade, if they existed at all, at the time existing multilateral organizations for international business were established, and services industries are distinct enough from goods industries that the two should stand separately. A Latin American executive adds, in support of a new organization, that existing organizations are too heavily directed toward the problem of the developed countries, while the needs of the less developed countries are given short shrift. A new organization would, in his opinion, remedy these handicaps.

Several respondents opposed to this approach also explain their attitudes. Most frequently mentioned is the belief that a new organization with its new bureaucracy will cost too much for the small benefits that may be achieved. Others point out that trade involving goods and services is not distinct; in fact, many believe the two are becoming increasingly intertwined. An effort to deal separately with trade issues in the two sectors will lead to confusion and inefficiency. Finally, the opponents argue that a new organization will take too long to achieve any successes in eliminating obstacles to trade now and that the uncertainty about the usefulness of a new organization will weaken its effectiveness.

General Bilateral Agreements Covering all Services

Bilateral agreements on general trade and investment principles for all services industries generate slightly more support among participants than a new multilateral organization. The support for this approach, however, comes only from North America. None of the participants outside the United States and Canada indicates any interest in using bilateral agreements on general trade principles to remove obstacles to the services industries. The North American interest can be and, by some firms, is specifically attributed to the bilateral trade negotiations begun in May 1986 between the United States and Canada. These negotiations cover many issues affecting both the services and the goods industries.

Several reasons are given by supporters of this bilateral approach:

— It permits consideration of the difference in strength of the services industry sectors on a country-by-country basis.

— It allows a services trading country to focus its negotiations on countries of greatest interest to the services industries that it wants to promote abroad.

— Bilateral negotiations are easier and more manageable than multilateral negotiations. Further, they are usually concluded more quickly than multilateral negotiations.

— By including all services sectors in one agreement trade-offs among them can contribute to the success of the negotiations—a flexibility not available when the negotiations are concerned with a single industry or one related group of industries.

— Negotiations on a country-by-country basis allow easier and more complete consideration to be given to cultural differences. These differences are often so many and so complex that they tend to be overlooked or shunted aside in multilateral negotiations.

— Several respondents believe that the successful negotiation of general bilateral agreements can set a useful precedent for future multilateral negotiations at GATT or elsewhere.

One respondent suggests that instead of initiating new general bilateral negotiations a more traditional approach should be used. FCN (friendship, commerce and navigation) treaties should be strengthened. These agreements, which have a long and honorable history in international relations, are usually signed soon after two countries formally recognize each other's existence. FCN treaties cover trade, consular, immigration and many other matters that affect commercial relations between two countries. The respondent who made this suggestion believes that the strengthening of the FCN treaties to cover the issues of concern to the services sector may obviate the necessity of new agreements.

Several participating firms, mainly from Europe, but including others from Canada and the United States, oppose any bilateral approach to removing trade barriers. They are concerned mainly that bilateral efforts will weaken or even break down the multilateral trading system that they believe is necessary to the world today. Country-by-country trading rules will in their view, jeopardize the establishment of uniform trading regulations that are necessary to prevent competitive distortions of the world trading system.

Bilateral agreements, other respondents contend, fail to reflect the global nature of many services businesses such as banking, telecommunications, air transportation and ocean shipping. Because these services operate in a world market, fragmented bilateral approaches to removing obstacles are unwieldy, complicated and confusing.

Finally, as a Scandinavian executive asserts, bilateral negotiations are disadvantageous to small nations. A small nation cannot bring the necessary clout to bilateral negotiations when dealing with much larger nations. This disparity can be overcome, at least in part , in multilateral negotiations where small nations can combine on issues of common concern.

Industry-specific Bilateral Agreements

Bilateral negotiations covering one specific industry or a related group of industries receive much more support from survey participants than do general bilateral negotiations covering all services industries. While slightly more than one in ten of the responding companies support the general bilateral approach, more than one-third support the industry-specific approach by itself or in conjunction with an existing multilater-

Reported Advantages of Alternative Approaches to Eliminating Barriers to International Trade and Investment in Services

GENERAL	INDUSTRY-SPECIFIC
In principle no difference between trade in goods and services. This is better understood and clarified by a general approach.	Real distinctions exist between goods and services and among services themselves. They can best be handled in industry-specific negotiations.
Because services trade is becoming increasingly intertwined with goods trade, regulating their trade together will be more effective and more efficient.	Experts on particular industries can be used more effectively.
A general approach is more flexible, allows more effective trade-offs in negotiations, and, therefore, gives better chance for success.	Less chance for sacrificing interests of one industry to gain benefits in another.
	Gives more attention to interests of the smaller industries in the services sector.
	Less complex and clumsy than dealing with many industries at one time.
	Negotiations can be concluded more quickly.
	Decisions more readily enforceable.
MULTILATERAL	**BILATERAL**
Recognizes global nature of many services industries.	Easier to consider country-by-country differences in services industries.
Negotiations in this context can establish uniform trading regulations for whole world and thereby strengthen world trading system.	Can consider national cultural differences.
Easier to see that all nations receive equal treatment.	Each negotiating partner can focus on other countries of greatest interest to itself.
Less fragmented, confusing and unwieldy arrangements.	Can limit or exclude irrelevant political issues that enter into multilateral negotiations.
Effective forum for small nations that have no clout in bilateral negotiations with large nations.	More manageable than multilateral because less complex.
	Can be concluded more quickly.
	Less costly.
	Can be used as precendent for later multilateral negotiations.
EXISTING	**NEW**
Established organization and bureaucracy with procedures and experience.	Better able to handle problems of emerging and expanding services industries.
Has existing body of decisions that can be used as precedents in new trade issues.	Can give more attention to less developed countries.
More efficient.	Can establish more safeguards to prevent sacrificing the interests of some industries with less influence politically than others.
Can act more quickly.	Can act more quickly because not hamstrung by previous trade decisions and ongoing political disputes.
Less costly.	
Successes in past give more clout to applications of principles and standards to new trade issues.	

al organization that would expand its activities to include the services sector.

Among the individual services industries in this survey, the industry-specific bilateral approach is especially supported by the transportation and shipping group (68 percent), tourism services (57 percent), and the miscellaneous group of services (55 percent). More than a third of the industry respondents in banking and in business services also find this a useful alternative to improve trade in services.

The most frequently cited reason for the attractiveness of this approach, as could be expected, is the fact that it can be targeted to the particular needs of a specific industry. The services sector covers a wide variety of industries linked together more often because they do not produce tangible goods than by any similarity in the services they do produce. This fact raises doubts in the minds of many respondents that the problems of international trade in their particular industry can be usefully resolved by linking them with dissimilar services industries in any kind of general negotiations covering the whole services sector. A U.S. engineering executive makes this point clearly: "There is little doubt that the engineering construction business is a service business that is quite different from

the other services industries, so any negotiation would have to be specific to our industry." The same point, only substituting the name of their own industry for engineering construction, is made by other U.S., Canadian and European executives in retail services, financial services, telecommunications and other industries.

Closely related to this concern is another reported by executives of firms in smaller services industries. They believe that negotiations covering all services industries will overlook the special needs of the smaller industries. A travel services executive, for example, believes the interests of the financial services industries (banking, insurance and nonbanking financial services) would overwhelm those of the travel industry if the two distinct groups are linked together in some kind of general negotiation.

A Canadian executive of an insurance company that operates in one services industry (insurance) in one foreign market (the United States) stresses the importance to his company and to those in similar circumstances of limiting negotiations to a bilateral, industry-specific approach. Besides considering the differences among industries, this approach allows negotiators to consider differences among individual countries and, where relevant, between categories of countries—such as developed and less developed. By limiting negotiations to specific industries and countries, irrelevant political issues can be excluded or at least reduced in significance along with the trade-offs that often result from the introduction of such issues to negotiations covering many industries.

The point that bilateral negotiations, whether industry-specific or covering all services industries, will be more quickly concluded with success than any kind of multilateral negotiations is made by many respondents. The factor of delay in negotiations is more often attributed to the number of countries involved than to the number of industries being covered, although an increase in the number of industries included in negotiations is seen as having some, but less significant, delaying effects on negotiations.

The arguments of opponents to the industry-specific bilateral approach are the same as those reported by opponents to bilateral negotiations on all services industries together: the trading system will become increasingly fragmented, weakened, unwieldy and confusing.

Industry-specific Multilateral Agreement

Fewer than half the number of companies supporting an industry-specific *bilateral* approach support an industry-specific *multilateral* approach. The main reason for this is the belief that several multilateral agreements and the resulting network of administering organizations will be much too costly for the limited benefits achieved by dividing an existing (or planned) general multilateral organization into several industry-specific multilateral organizations. A multilateral arrangement, furthermore, cannot consider individual country differences to the same extent as bilateral arrangements without becoming unduly complex.

Thus added to the cost argument is the belief that setting up several new organizations will result in a trading system that would be complicated, confusing and inefficient—and would take much too long to solve trade problems in the services sector that need solutions now.

Support for the industry-specific multilateral approach is based on points similar to those reported by proponents of industry-specific bilateral arrangements: recognition of the important differences between services industries; more expertise available for solving the trade problems of one targeted industry than can be considered when all services industries are lumped together; and action for one industry can be taken more quickly than for all.

An added argument particularly favoring multilateral negotiations over bilateral is made by a European insurance executive. Small countries find it easier and more advantageous for their trading interests to negotiate with the support of other small nations in a multilateral context.

An Existing Multilateral Trade Organization

Working through an existing multilateral trade organization expanded to include the services sector draws the endorsement of the largest number of participants in the survey. Some 40 percent of the respondents support this approach—alone or coupled with one of the other suggested approaches, most often the industry-specific bilateral approach.

Support for this alternative shows a significant regional distinction: While approximately one-third of the U.S., Canadian and "other country" respondents support this approach, two-thirds of the European participants endorse it.

When considered according to the number of industry responses in this survey, the support for this alternative is still stronger: More than 70 percent of the companies in business services and in telecommunications support this approach, as do more than half the firms in transportation and shipping, tourism, nonbank financial services, banking, and professional services.

Only in insurance, retail stores and the "miscellaneous" group of services do fewer than half the firms consider this alternative as the best means to eliminate trade barriers in their fields of interest.

The wide support among participants for this approach is explained by several factors:

— Trade in goods and services should be linked together in one organization to demonstrate that "in principle" there is no difference between these two kinds of products. By lumping them together both developed countries and, more importantly, less developed countries will see how the two kinds of products are tied together in one trading system. Negotiating on *all* internationally traded products in one organization will be more effective in eliminating trade obstacles than would be any effort at piecemeal solution—industry by industry or separating goods and services.

— An existing organization will already have a body of decisions on trading matters that can be used to guide future decisions. There would be no need to reinvent basic international trade principles and standards. They have already been estab-

lished and recognized, thereby providing fundamental stability to the international trading system.

— Using a successfully functioning multilateral organization will make it easier to see that all nations receive fair and equal treatment in international trade.

— Expanding an existing organization to include more industries and, possibly, more countries will give it more clout to implement effectively the principles and standards it sets up for improving the international trading system.

— Using an existing organization with established procedures and experienced bureaucracy will be more efficient, and, therefore, less costly than setting up a new organization with a new bureaucracy.

The opponents to use of an existing multilateral trade organization to remove obstacles to world trade in services believe it is a mistake to lump goods and services together. They believe such linking makes such an organization too complex and clumsy to be effective as a means to eliminate barriers to services trade and increases the chances of a breakdown in any efforts toward that goal. Even if there is no complete breakdown, the process of resolving international trade problems will be greatly slowed when so many disparate industry and national views must be taken into account. The difficulties of enforcing guidelines developed primarily for the goods industries will be greatly increased when applied to the less clearly defined and often intangible service industries. Finally, several opponents believe that putting all industries together in one large existing organization may lead to sacrificing the interests of some industries to promote others, and they fear the possibility that the interests of their own industry and firm may be the ones sacrificed. One transportation executive explains this view: "Transport—and air transport in particular—is still too vital worldwide to be subjected to the vagaries of tradeoffs against wheat or oil or information and telecommunications technology. The air-transport sector does not always behave according to established principles of economics, is highly capital intensive and, therefore, vulnerable. Our strong preference would be to have air transport remain totally outside the scope of any general international trade agreement."

What Existing Organization Should Be Expanded?

As might be expected, considering that preliminary talks on including services within its area of responsibility have begun, GATT is the existing organization with the most support. Thirty-five companies suggested adding services to the responsibilities of GATT. Second, but with only seven proponents is the Organization for Economic Cooperation and Development (OECD). Several of those who choose OECD refer specifically to the potential expansion of its Code of Liberalization of Current Invisible Operations, adopted in 1961. This code covers trade in international services, at least in principle. But OECD members have attached so many reservations to its use that much effort would need to be expended to make it an effective instrument for the elimination of barriers to the services trade in today's world.

The European Economic Community is suggested by six companies (all European) as the appropriate organization. The International Monetary Fund is proposed by two banks. The Bank for International Settlements, the United Nations Conference on Trade and Development (which already has a code on one services industry—shipping), the International Shipping Federation, and one nongovernmental organization, the International Chamber of Commerce are each suggested by one responding firm.

In addition to the reasons already given above for choosing an expanded existing multilateral organization as the best means to eliminate barriers to services trade, GATT draws support largely because it is seen as an experienced organization, firmly established, with a broad membership, and a record of success in eliminating tariff barriers and reducing nontariff barriers to international trade in goods. Its achievements in the form of codes and accepted principles have been incorporated into the national laws of many of its member nations. In the view of many survey participants, this record gives GATT more chances of success if it were used to provide oversight to trade in services as well as in goods. An executive of a U.S. professional services firm illustrates this view: "The GATT is the preferred instrument because it has significant experience in international commercial matters, a broad membership, and recognized dispute-settlement and enforcement provisions—all of which are critical to the effectiveness of a services trade and investment regime."

Against the expressed support for GATT, however, several other survey participants make explicit reservations about its usefulness for ending trade barriers for the services sector:

— GATT negotiations take too long.

— GATT is already too broad and complicated to be completely effective. Adding the services sector to its agenda will further decrease its effectiveness.

— GATT has been concerned so far with traditional goods manufacturing industries and is the wrong forum for the new information-based industries.

— "GATT negotiations are frequently subject to political retribution that extends beyond business economics." (A U.S. transportation company.)

— "Organizations like GATT seem to be poorly adapted to serve underdeveloped countries fairly on a one-to-one basis with developed nations." (A Latin American entertainment company.)

One way to overcome the limitations to using GATT for services is suggested by more than a dozen of its supporters. The multilateral arrangements of GATT and the industry-specific bilateral arrangements favored by the second largest number of survey participants could be joined together into an integrated system to regulate international trade and investment in services. A U.S. accounting firm executive makes this point: "The best means of reducing or eliminating impediments to the international operations of accounting organizations is to negotiate multilateral rules through the General Agreement on Tariffs and Trade. The negotiations should lead to a framework agreement with general principles applying to all services and sector agreements adapting and implementing these

general principles to the requirements of specific service industries."

Suggestions to Negotiators

Participants in the survey were asked an open-ended question on what advice they would give to their countries' negotiators preparing for any future negotiations to eliminate obstacles to international trade and investment in services. More than half the respondents replied with specific suggestions, some of which apply to particular industries. Among these are: Eliminate subsidies and preferential loans in offshore construction; lift national restrictions on transborder data flows for the telecommunications and banking industries; provide a unified documentation and classification system for the shipping industry; eliminate governmental cargo reservations (also for the shipping industry); promote the harmonization of national banking regulations; and for two banks, keep their industry out of any new GATT negotiations.

The majority of suggestions, however, are more general. Most frequently suggested is the request to push for the most open and free trade possible for all services industries with equal access to all markets in all countries.

Second, negotiators are urged to seek reciprocity in services trade. Each nation should grant only those trade privileges it receives from others and should be allowed to restrict its services imports to the extent other nations place restrictions on its exports to them.

Third, participants advise their negotiators to promote the principle of national treatment, that is, foreign national firms are to receive the same treatment as domestic firms in the same industry within the nations party to the trading agreement.

Fourth, governments joined in any new trade negotiations should permit representatives of the industries concerned to participate in the negotiations.

Fifth, and directly related to the fourth: If the participation by industry representatives in the negotiations is inappropriate, then government negotiators should be more thoroughly briefed before and during negotiations on the positions of *all* the industries to be covered in the negotiations and not just on the large industry groups. For the services industries as a whole, the negotiators should be informed about the growing importance of the trade in services compared to the trade in goods with which international trade negotiations have traditionally been more concerned.

Sixth, for federal governments, such as the United States and Canada, negotiators should be fully aware of the regulatory roles and responsibilities of their sub-national governments for particular services including insurance, banking, construction, and professional services requiring state or provincial certification.

Each of the above six suggestions was made by four or more respondents, but many other suggestions were made by fewer participants. They include:

— Be prepared to open negotiations to new issues not considered in any earlier negotiations involving trade in goods

— Promote the right to establishment for services industries that need to produce their products at the place where they are consumed.

— Consider general international economic factors, such as more balanced national growth and exchange-rate stability, as they affect the services trade.

— Be ready to take a tough negotiating stand including a willingness to retaliate, but make that stand clear to other negotiating countries. Do not launch surprises at the negotiating table.

— Keep negotiations short. Do not let them drag on until they themselves become an impediment to success.

— Include the protection of intellectual property as part of any new negotiations on trade in services, and remember that other less directly related issues, such as those involving agriculture, are also part of the overall trade-negotiating endeavor.

— Protect cultural sovereignty especially against the dominance of foreign firms in such areas as publishing and entertainment.

— Recognize the difference between services performed within one country (e.g. resort hotels or construction) and those regulated jointly by two or more governments (e.g. air transportation and telecommunications).

— Study existing bilateral agreements covering services as possible precedents for a new multilateral agreement.

— Use all available tools for negotiating. For example, do not hesitate to link continued GSP (Generalized System of Preferences) benefits to opening markets to services trade.

— Trade negotiations should be insulated as much as possible from political pressures resulting from changes in political leadership.

— Eliminate local ownership requirements.

— Continue to collect information on what are really the barriers to international trade and investment and where they exist.

— Eliminate existing barriers to services trade and investment among political subdivisions at home first.

— Insure equal treatment in the world's trading system for both developed and less-developed countries.

— Negotiate agreements that can be enforced effectively and that will last.

— Before getting too involved in services, act to reduce the growing worldwide protectionist trend involving trade in goods.

— Finally, an important piece of advice as summed up by an air transport executive: "While urging an equitable but tough policy, do not fear change."

The executives submitting these suggestions clearly recognize that, while sharing many common concerns and generally accepted trading principles with producers of goods for international trade, the services industries have several different areas of concern that need different approaches for their resolutions. Underlying their replies is the implicit (and in some instances, explicit) belief that international trade should be kept as free as possible, but that some remedies, either bilateral or multilateral, are needed to foster greater fairness for all participants in that trade.

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Research Bulletin

No. 203

The Conference Board

The 1987 Economic Outlook: No Recession, No Resurgence

Summary of a meeting of
The Conference Board Economic Forum

Management Summary

- The Forum consensus points to a "more of the same" forecast for 1987—more of the same moderate growth in economic activity and more of the same inflation and interest rates we have now.
- Underneath this surface tranquility lurk strong crosscurrents, especially in consumption and international trade. Although consumers will not reverse course, they are expected to play a passive rather than an active role in next year's economic advance.
- Foreign trade will step into the leadership role, however, as our import-export balance takes a turn for the better. The shift will be gradual, but a modest change in direction is all that's necessary to add a sizeable increment to the U.S. growth rate.
- A number of serious policy issues threaten this favorable outlook, including the budget deficit, monetary policy, and protectionism. These dark clouds are on the horizon, however, not massed directly overhead.

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November 10, 1986

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An Uninspiring but not Unsatisfactory Forecast

Edgar R. Fiedler

Members of The Conference Board Economic Forum, convening in mid-November for their annual discussion of the business outlook, found themselves pretty much in agreement on a "more of the same" forecast for the overall economy in 1987. They look for more of the moderate and fairly steady advance in total activity that has prevailed since mid-1984, and more of the present level of inflation and interest rates. (For numeric projections, see table on page 4.)

This no-change forecast for the economy as a whole does not mean that no change is taking place *within* the economy. Quite the contrary. Beneath the apparent tranquility on the surface, strong crosscurrents are at work in almost every important sector. Residential construction, for example, which was first a contributing and then a sustaining factor during 1986, will weaken in 1987 when tax reform pulls some of the props out from under multifamily housing starts. Business capital investment, which dropped sharply in mid-1986—predominantly in the oil patch where capital outlays plummeted a breathtaking 40 percent—should stabilize or move slightly upward next year. Business inventories, a drag on output since early this year, are seen as providing some forward thrust during the year ahead.

By far the most important shifts in direction will take place in personal consumption and foreign trade. These two sectors are clearly the keys to the 1987 outlook. Consumers have been the driving force behind the expansion throughout the past year, with spending growth that far outpaced the rest of the economy. In the process they've drawn down their saving rate to well below normal, which suggests that they have no reserve buying energy left to contriubute to economic advance in 1987. In addition, surveys of consumer sentiment now show a lack of exuberance. From here on, despite the lift tax reform will impart to disposable income at the beginning of the year, the consumer has to be thought of as a passive agent in shaping the 1987 economy. Total personal outlays will continue to rise, but more slowly than in 1986.

The slack should be taken up by foreign trade. The international worm is beginning to turn. The import binge we've been on is slowing, and exports are strengthening in a variety of industries—wood products, textiles, chemicals, machinery and others. The change will be modest and gradual, to be sure, and not all our trade-troubled industries will see much improvement. But where deterioration in the trade account curtailed GNP growth sharply in 1986—pulling a growth rate that would otherwise have been 3.5 percent down to a rather ordinary 2.2 percent—the reversal now in progress will boost output in the year ahead. Even a modest shift in direction will add a sizeable increment to the U.S. growth rate.

Edgar R. Fiedler

"The dark clouds are not massed directly overhead."

What all these changes in direction among the major sectors add up to is not easy to discern. Bruce Lippke compared forecasting the economy under these circumstances to a quarterback trying to pass the football in a blizzard: A tough task made tougher by poor visibility and slippery footing. But as best the Forum members can judge, the pluses and minuses offset one another in a surprisingly evenhanded way. As a result, the United States economy seems to be headed for another year of moderate expansion—at a growth rate of about 3 percent. Although this is an uninspiring pace of advance, it is not unsatisfactory. Moderate growth is preferable to vigorous expansion, if the latter leads, as it might, to more inflation or an early downturn.

It is, of course, not difficult to alter this projection in either direction. A forecaster needs only to assume a slower turnaround in the trade balance and some purse-tightening by consumers and—Poof!—the projected expansion vanishes. Alternatively, a faster pick-up in foreign trade and just a bit more of a free-spending mood by consumers would impart a nice glow of buoyancy to growth in 1987. The Forum doesn't rule out those two possibilities, but most of the group feels that either a business cycle downturn or a full-fledged boom is unlikely.

For this same reason—no recession but no resurgence either—inflation is unlikely to be dislodged very far from its

average pace of the past few years. In early 1986, the dramatic drop in oil prices brought about an actual decline in the consumer price index. Yes, that's right, not just disinflation but deflation! In recent months, however—once the price of oil stablized and the direct effects of its decline had worked their way through the system—the CPI has begun to climb again, at about the 3.8 percent rate of 1985.

Members of the Forum are divided on whether 1987 is likely to see inflation accelerate slightly or decelerate slightly. On the upside, rising prices of imported goods—reflecting the declining international value of the dollar—could lift the inflation rate a notch or two. Others argued that, with unemployment near 7 percent, the economy has sufficient slack to bring additional disinflation to both wages and prices. In either case the effect is seen as modest.

The same pattern applies to interest rates. In the context of our expectations for the economy and inflation, demand and supply in the credit markets are seen to be in close balance. Will the Federal Reserve change this? Maybe, but for now the group sees the Fed more or less equally concerned about recession and inflation, which also suggests little movement in interest rates. Accordingly, although there are different views about the direction of interest rates, the differences are narrow.

Policy Dilemmas

The Forum also chewed on a number of structural issues, most releated to economic policy, that seriously threaten the long-run stability and viability of the economy. The discussion of tax reform, for example, identified so many conflicting effects on specific sectors of the economy that the macroeconomic impact seems almost indecipherable. From a long-range perspective, all or nearly all of the group favor the legislation, but for somewhat different reasons and with significant reservations.

The budget deficit poses several uncertainties. The Gramm-Rudman-Hollings legislation is a dead duck—killed by the indecent transparence of the bookkeeping artifices used to meet its target for fiscal 1987. The corpse has no death certificate, however, and the undertakers won't take it to the morgue. Thus no one sees the uptrend of government spending returning to its business-as-usual pace of earlier years. At the same time, chances are remote that Congress will enact either program cuts or tax increases in 1987. Whether new additions to spending can also be avoided is one uncertainty. If so, the budget deficit appears to be locked onto a stable or gradually declining path—the path that was forged over the past two years by the drastic slowing of the military build-up and the curtailment of a number of domestic programs. The dilemma here is that while the disappearance of the Gramm-Rudman targets relieves anxiety that a too-rapid move toward fiscal restraint would push the economy into recession, it also leaves in place large chronic deficits that pre-empt the capital investment needed to improve the nation's sluggish productivity trend.

Monetary policy provides its share of perplexity, too. One difficult question is why the interest-rate decline of the past couple of years has not produced a greater cyclical response in the form of stronger economic expansion than seen to date.

The Forum Consensus

Results of a Pre-Meeting Outlook Survey

			Projected		
	Actual 1985	Actual III 85 - III 86	Fourth Quarter 1986	1987 Median	1987 Range
Economic Growth (Real GNP, percent change)	2.9	2.2	3.0	3.0	1.5 to 3.2
Inflation Rate (GNP Deflator, percent change)	3.3	2.9	3.1	3.8	3.5 to 4.0
Corporate Profits (Before taxes, percent change)	7.8	2.9	7.9	6.5	5.0 to 13.5
Unemployment Rate (Percent, average during fourth quarter)	7.0	6.9	6.9	6.7	6.5 to 7.2
Commercial Bank Prime Rate (Percent, average during fourth quarter)	9.5	7.8	7.5	7.6	7.0 to 8.5

	Actual	Projected	
	FY 1986	FY 1987	FY 1988
Federal Budget Deficit (Billions of dollars)	221	188	170

Note: These forecasts incorporate submissions by Forum participants in early November, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1986 IV to 1987 IV; the forecasts for the fourth quarter of 1986 are at seasonally adjusted annual rates.

The answer *may* be simply that declining interest rates did in fact provide their usual stimulus to the economy, but the deteriorating trade balance and other forces imparted more offsetting restraint than we recognize. But perhaps not, and the question remains whether what we once thought to be a fairly reliable link between monetary stimulus and economic expansion is still intact. If not, will monetary policy, now evidently the only major discretionary policy tool available, have the capability to attenuate and reverse quickly the next recession when it appears?

A similar question concerns the way monetary policy is carried out. Since 1979, the Federal Reserve has paid increased attention to the rate of growth in the monetary aggregates. Recently, however, the relationship between economic activity and the various measures of money supply appear to have lost some of the reliability once ascribed to it. Consequently, the monetary authorities now must focus less on money growth as a dependable steering mechanism for guiding the economy and instead depend more heavily on interest rates and various indicators of economic performance. As Lyle Gramley put it, they must fly more by the seat of their pants. The risk of veering off course into recession or inflation may thus be greater than we used to believe.

Finally, our international policies pose uncertainty. One thing that's not clear is which industrial country might serve as the "locomotive" to pull the world business cycle onto the track of faster expansion. More likely, as Eric Kruger noted, the railroad metaphor is inappropriate; the present situation is better described as a disorderly mule train!

The absence of vigorous growth in the industrial world exacerbates two important problems. One is the heavy debt burden of some developing countries, whose recovery to economic health will be slower and more painful.

The second is the threat that serious protectionist measures may be put in place. In the United States, the decline in the exchange value of the dollar and the shift of direction in the trade balance will reduce the pressure for new barriers to imports in many industries, but not all. Forum members agree on the importance of both "free trade" and "fair trade"—which are in fact the same thing. But they worry that the hard bargaining necessary to gain unfettered access to specific foreign markets could backfire in ways that would lead to more rather than fewer barriers to international trade, thus compromising both goals.

In the end, none of these dilemmas and uncertainties about economic policy deterred the Forum from projecting further moderate growth for 1987 with no substantial dislocation of the present structure of inflation and interest rates. The policy concerns are serious, but the threats they represent to the economy do not appear to be imminent. Indeed, none of the participants looks for the next business recession to get underway until 1988, and most think it will be 1989 or later. The group has no difficulty finding dark clouds on the horizon, but for now at least they are not massed directly overhead.

The Cyclical Setting

Albert T. Sommers

Midway in the final quarter of 1986, the U.S. economy is giving a reasonable but still unconvincing account of itself. For the past six weeks, it has been experiencing a seventh bubble-like revival of statistical growth; all the other six bubbles of optimism since the system turned sluggish in the middle of 1984 evaporated in a matter of months. And it is not clear yet whether the present improvement will avoid the fate of its predecessors.

This latest bubble is composed of a better level of manufacturers' orders, widely distributed among industries, and a considerable improvement in shipments — in the presence of little or no change in inventories, so that inventory-shipments ratios have declined. Employment has continued to grow at a 2 percent annual rate. Retail trade has been moderately strong (extremely strong if the special strength in the automobile market were not to be excluded) but demand in most of the other sectors of the domestic economy seems on the whole to be no better than stable, and the flow of personal income that must support the growth of the personal outlay has been strikingly low.

These modest and rather sparse indications of faster growth in the domestic economy have been reinforced, this time around, by better evidence with respect to its international behavior — some degree of strengthening of the dollar against both the yen and the mark, two consecutive months of decline in the trade deficit (reflecting some subsidence of imports, but no real growth for its own exports) and bilateral arrangements

Albert T. Sommers
"Sparse indications of faster growth."

with the Japanese that included a reduction in the Japanese bank rate, and some assurances that it will seek better growth for its own economy. It is these international considerations, more than the thin collection of more favorable evidence on the domestic economy, that lend some substance to the modest indications of growth that can be found in recent figures.

All of this does not add up to a portrait of the beginning of cyclical growth; in fact, the traditional cyclical behavior of the system that rests on fast transmission of strength and weakness from one sector to another has been strangely absent for over two years. It is as though the interconnections among the parts of the system have been blocked or attenuated. The business cycle is predominantly an industrial phenomenon, and predominantly a goods phenomenon; it gains its strength from the interconnections between goods demand, inventory demand and the resulting capital goods demand. Viewed this way, it seems pretty obvious that the development of the huge trade deficit of the past few years has numbed the cyclical machinery of the system, insofar as real demands are concerned, and its suppression of price strength in the industrial sector has killed off the the speculative and anticipatory demands.

To develop into a more nearly cyclical growth rate in 1987 would therefore seem to require a significant and persistent decline in the trade deficit. But even forecasts (such as my own) that envision a considerable degree of reduction in the deficit nevertheless generate only moderate growth, since the responsiveness of a number of other sectors — plant and equipment, housing, the rate of Federal outlay for goods, and perhaps even consumption demand — is unlikely to improve importantly in the near term, even under conditions of a subsiding trade deficit. The most likely course for the economy, therefore, is for very sluggish performance in the first half of 1987, and then a return to 3 percent growth almost a year from now.

Politics And The Economy

Isabel V. Sawhill

According to the Democrats and some columnists, the 1986 election marked the end of the Reagan era and of a trend toward greater conservatism in our national life. This is too strong a conclusion. First, the election was about local issues and personalities; it wasn't a referendum on anything. Second, the Democrats have been at last partially "Reaganized." They're not talking about new spending programs, raising taxes, or cancelling SDI. Third, the Republicans took over 8 of the statehouses and suffered far less of an electoral loss than is typical for the out-party in the sixth year of an adminstration. Fourth, in spite of the surprising Democratic pick-up of 8 seats in the Senate, many of the new Chairmen — especially on such key economic committees as Appropriations, Finance, Budget, and Commerce — are as conservative as the Republicans they are replacing. Finally, exit polls show that the number of voters who describe themselves as Republican or "conservative" has drifted up since 1980 and that a plurality of voters think that the Republicans do a better job than the Democrats at handling the economy as well as other issues. Thus the election provides no mandate for the Democrats to go back to business as usual.

Nevertheless, there are signs that the voters are both weary of, and wary of, ideological solutions to the nation's problems. The public is looking for a government that *works*, whatever its size. Supply-side economics is, if not dead, certainly moribund. Support for the religious right's candidates and issues appears to be minimal. Concern about the budget and trade deficits remains high, though the public doesn't really understand these issues and is easily turned off by abstract discussions of them.

The 100th Congress will have to deal with these concerns. Both deficits are expected to peak in 1986 and gradually decline thereafter, barring a recession. This will remove some of the pressure to do something about them — probably a good thing in the case of trade but a bad thing in the case of the budget.

Isabel V. Sawhill

"On the budget, continuing stalemate."

Democrats have put trade at the very top of their agenda. Senator Lloyd Bentsen (D-Tex.), the new chairman of the Senate Finance committee, is promising action by spring and will likely get support from such key Republicans as Sen. Robert Dole (R-Kan.) and Sen. John C. Danforth (R-Mo.). Although he is pro-business and not an outright protectionist, Sen. Bentsen sponsored last year's bill that would have put an import surcharge on goods from countries that restrict imports from the U.S. Access to foreign markets is likely to be the centerpiece of any legislation. The President would almost

certainly veto anything that smacked of protectionism, but he only barely succeeded in blocking the textile bill last year, suggesting that the Congress may win this one in 1987.

Unlike politicians, most economists think the solution to our trade problems will come not from trade legislation but from getting the budget deficit under better control. Unfortunately, prospects are for continuing stalemate on this front. The President is likely to hang tough on defense and taxes; the Congress has already curtailed his defense requests substantially with the result that defense outlays are now on a downward path as a proportion of GNP; social security is off limits; there's not much left to go after in the rest of the budget; and few think the Democrats will be brave enough to propose raising taxes in the face of continued White House opposition. An oil import fee could produce some revenue and there might be an attempt at further base-broadening as part of a second round of tax reform, but this wouldn't be any easier to pull off than round one. Thus, in place of real progress on the deficit what we are likely to see is more discussion of the budget process itself, including Gramm-Rudman, which may be scuttled in the face of a large gap between the target for FY1988 ($108 billion) and the deficit projected for that year ($170 billion?). It will also be argued that complying with the targets could be bad for the economy in the short run.

All in all, it is not an encouraging picture. If the economy continues to recover, it will be because of its natural robustness and not because anyone in Washington (other than the Fed) is taking constructive action.

Thoughts on Tax Reform

John H. Makin

I wish to draw four conclusions regarding tax reform: It will not precipitate a recession. It does not represent an ideal income tax code, but it probably realizes about half the gains available from thoroughgoing reform of an income-based tax system. Its major strengths are its increased incentives for economically motivated, rather than tax motivated, decisions by households and corporations and the incentives it provides to reduce the build-up of private sector debt that now threatens continued economic recovery. Its major weakness is its failure to index provisions related to the taxation of income from capital. Faster inflation would reduce investment incentives because of the bill's failure to index capital gains, depreciation measures, and inventory allowances.

On the first of these points, weakness of the economy has raised the fear that we may be poised on the brink of a recession. Therefore, it is said that the reform legislation, by increasing the tax burden on corporations especially through the rescission of the investment tax credit, will push the economy over the brink. We may well be facing a recession, but public-sector debt accumulation (budget deficits) and private-sector debt accumulation (trade deficits) are the culprits, not tax policy.

The legislation raises the cost of capital by between 5 and 10 percent if it is assumed that interest rates are unaffected. Nevertheless, the lower tax rates and limitations on household borrowing will slow debt accumulation and produce lower interest rates. The impact on the cost of capital will be small, if there is any at all.

If the repeal of the investment tax credit (ITC) were unanticipated, it would produce a temporary, negative impact on capital formation. It is likely that the removal of ITC has long been anticipated and that its major negative effects appeared during the first quarter of 1986 when nonresidential fixed investment fell at a 15.1 percent annual rate. The decline slowed to a 2.3 percent annual rate in the second quarter. Since 1962, when the ITC was first employed, it has been modified, suspended, and reenacted eight times. The expected life of an unamended investment tax credit is two to three years. Therefore, its removal five years after its last modification in the Economic Recovery and Tax Act of 1981 should hardly come as a surprise.

John H. Makin

"Reintroduction of ad hoc corrections is a major risk."

The reform bill forgoes, presumably for sound political reasons, two major base broadeners: the preferential treatment of owner-occupied housing and full deductibility of state and local taxes, other than sales taxes. These exceptions to base broadening relinquish $70 to $80 billion per year in potential revenue and thereby limit achievable rate reductions and preordain an increase in corporate taxes to finance politically attractive and economically useful tax rate reductions for households and businesses.

A closer-to-ideal reformed income tax system would be the Treasury I plan of November 1984 with preferences for owner-

occupied housing removed. Total welfare gains under such a plan would be roughly double those achievable under the conference agreement.

Through rescission of the investment tax credit, lower corporate tax rates and lower tax rates on households, tax reform sharply reduces the disparity across tax burdens on alternative forms of investment. The agreement therefore increases the incentive for scarce investment funds to be allocated to projects that are intrinsically attractive from an economic standpoint rather than from a tax perspective.

The bill's lower tax rates and limitations on household borrowing will slow private-sector debt accumulation. The lower rates themselves plus the slower rate of debt accumulation place downward pressure on interest rates that help to compensate for the increased tax burden on new capital purchases, resulting largely from rescission of the investment tax credit.

The weakest feature of tax reform is its failure to insulate the level and distribution of tax burdens on investment from changes in inflation. Accelerated depreciation, investment tax credits, and low tax rates for capital gains have in the past evolved as ad hoc corrections to "capital bracket creep." When inflation drives up replacement costs, unindexed depreciation schedules and inventory allowances leave corporations with artificially bloated profits and tax bills. Investors with paper gains on assets whose value has risen only with inflation pay taxes where none should be due. These shortcomings could be remedied with indexing provisions.

The major risk from "capital bracket creep" is that higher inflation will increase pressure to reintroduce these sorts of ad hoc corrections. This pressure will mean reopening the tax code every year or two as has become an unfortunate practice. The resulting increased tax code uncertainty penalizes investment by making difficult long-term planning regarding after-tax rates of return.

Summary

The legislation represents progress toward a more stable, less intrusive tax system. It signals a less activist role for government through the tax system, just as airline and trucking deregulation, an end to oil price controls and deregulation of financial institutions have marked a less activist role for government by other means. It also ends half a century of unsuccessful efforts to redistribute income through progressive taxes.

Looking ahead, one should keep in mind three facts that link the budget to the tax code: First, without a willingness to slow the growth of entitlement programs, required progress on deficit reduction will necessitate a tax increase. Second, an increase in the tax burden on capital above that incorporated in the reform bill could not be compensated for by lower interest rates and therefore would result in a net increase in the cost of capital and a slowdown in growth that would further increase the deficit. Third, in addition to large government dissaving represented by large deficits, America's private saving rate remains distressingly low. In sum, a country in need of revenue that saves too little ought seriously to consider eliminating or at least reducing the double tax on saving by enacting an expenditure-based tax system, such as a value added tax or a GATT-legal business transfer tax.

The Federal Budget

Van Doorn Ooms

It will no doubt be regarded as a sign of either imprudence or special pleading to argue, only days after a record Federal budget deficit of $221 billion for Fiscal Year 1986 was announced, that a remarkable change in the trajectory of total Federal spending has taken place in the last two years. Political rhetoric links large deficits to "uncontrolled spending," but the numbers show, in fact, a very sharp reduction in spending growth in the 1986 and 1987 budgets, principally driven by policy changes during the 99th Congress.

The spending slowdown has been obscured by the failure of the deficit to come down in 1986 and by the difficulty of reaching the unrealistic $144 billion deficit target in 1987. However, this is due largely to slower revenue growth from a disappointing economic performance and to sharply raised outlays in farm-income-support and deposit-insurance programs.

The current Congressional Budget Office (CBO) projection for total Federal spending in 1987 is remarkable—an outlay increase of only $5 billion, or 0.5 percent. Spending growth now appears to be running well under that of GNP, whereas the opposite was true in 1981-1985.

Much has been made of the impact on the budget estimates of the "blue smoke and mirrors" used to reach the Gramm-Rudman targets—creative accounting that moves money between fiscal years, asset sales with only one-year effects, and optimistic forecasts. (Critics of Gramm-Rudman were correct in at least one respect. It strengthens Gresham's Law of Budgeting, by which bad numbers drive out good.) Reference has also been made to the effects of the tax reform legislation in adding $11 billion to revenues in 1987—while removing $17 billion in 1988. It's possible to get a better look at the "fundamentals" of the recent fiscal actions by adjusting for these factors.

The table shows adjusted spending and deficit projections with most of the smoke blown away, with the tax reform revenue effects removed and with an economic forecast resem-

bling the current "consensus," with lower economic growth than used by CBO in August. The longer term pattern does not change appreciably although the 1987 deficit is substantially higher and the 1987 spending slowdown slightly less dramatic.

What happened to bring about this change in the spending trajectory? The main elements have been:

- Greatly increased restraint on defense appropriations in both 1986 and 1987. Budget authority in defense stands at $284 billion in the 1987 budget compared with $295 billion in 1985; defense outlay growth should fall from 11 percent to about 2 percent over the two years.
- The *level* of non-defense discretionary spending was successively reduced in both 1986 and 1987. Outlays in these programs are projected to fall from $172 billion in 1985 to $167 billion in 1987. Projected 1987 spending in this broad area of domestic programs is at the same dollar level as in 1981, implying a reduction in the real aggregate program level of about 20 percent over the six years.
- The Gramm-Rudman sequestration in the 1986 budget reduced the spending base in that year, with larger effects in 1987 and probably subsequent years.
- Even the relatively intractable entitlement and other "mandatory" programs saw a substantial slowdown in the aggregate resulting from regulatory action in health programs, new farm legislation and the elimination of revenue sharing. These programs are growing at *half* the rate of GNP in 1986-1987, whereas they grew significantly faster than GNP in 1981-1985.

Finally, what are the fiscal policy implications of the above? The table also shows structural deficits (cyclically adjusted to a 6 percent unemployment rate) associated with the projections. The fiscal restraint is impressive. Indeed, some will wonder whether the imposition of restraint—on which the consensus seems firm as a long-run matter—is too rapid in 1987. Yet, the Gramm-Rudman deficit targets of $108 billion in 1988 and $72 billion in 1989 imply significantly greater restraint. Furthermore, the required restraint would grow if the projected deficits (as so often in the past) are higher than those above when the 100th Congress convenes to consider fiscal policy in January. A vigorous debate on Gramm-Rudman, and perhaps on fiscal policy, lies ahead.

Van Doorn Ooms

"The spending slowdown is real, but will the deficit fall?"

Federal Spending and Deficits

(Fiscal years, $ billions or percent)

	1985	1986	1987	1988	1989
Unadjusted Projections					
Spending	946	990	995	1057	1105
Deficit	212	221	151	153	127
Adjusted Projections					
Spending	946	989	1005	1052	1105
Deficit	212	220	184	149	134
Cyclically Adjusted Projections					
Structural Deficit	168	189	128	126	114
Percent of Potential GNP	4.1%	4.2%	2.8%	2.6%	2.2%

Monetary Policy

Lyle E. Gramley

The Federal Reserve's policies in 1986 have clearly been oriented toward ensuring a satisfactory growth rate of the U.S. economy. In the February report to the Congress on monetary policy, the Fed indicated that members of the Federal Open Market Committee (FOMC) expected real GNP to increase by 3 to 3½ percent in the four quarters of 1986. During the next two months, the discount rate was lowered twice. In the July monetary policy report, the Fed indicated that real GNP growth over the four quarters of 1987 was expected to be 3 to 3½ percent. Within the next month and a half, two more reductions in the discount rate occurred.

Throughout 1986, the probability of recession in the U.S. economy has been small—nonzero, but small. Indeed, the economy has continued to advance at about the same moderate rate that has been in evidence since the middle of 1984. What explains the Fed's rather aggressive easing of monetary policy in 1986, particularly in light of the out-sized increases in the narrowly defined money supply?

The answer, I believe, lies in its judgment that economic growth among the major industrial countries is too slow. Growth of output in the industrial countries will be lower in 1986 than in 1985, and perhaps lower still in 1987 if activity in Japan and the U.S. does not perk up slightly. There is at least a remote chance that weak economic growth here and abroad will interact and produce a world-wide recession. Such an event would be a disaster. Even if that does not happen, growth of the industrial economies of less than 3 percent for a protracted period would offer little or no hope of satisfactory progress in resolving the debt problems of many developing countries. Those countries need the opportunity to increase their exports in the context of expanding world markets; otherwise, the threat of an international debt crisis will remain uncomfortably high.

Since August 21, 1986, the Federal Reserve has been marking time; no further easing actions have occurred. Signs of moderate improvement in the economy have developed, and the Fed clearly wants to wait and see whether the long-awaited strengthening of economic activity is at last underway. My expectation is, however, that economic growth will weaken again in early 1987, largely because of a diminished pace of consumer spending. Early next year, therefore, I expect to see further steps by the Federal Reserve toward ease, and moderately declining interest rates.

A major problem the Fed may have to face in 1987, and if not then in 1988, is deciding when to shift from a growth-oriented monetary policy to a policy posture aimed at the long-run objective of holding down inflation. A major problem it will face in this respect stems from the difficulty of using the monetary aggregates as policy targets.

Lyle E. Gramley

"Monetary policy is doubly difficult now."

Historical relationships between the growth of money narrowly defined (M1), gross national product (GNP) and the inflation rate seem to have broken down. In its July 1986 report to the Congress on monetary policy, the Federal Reserve effectively abandoned its M1 target range for the remainder of this year and set forth only a "likely range" for 1987.

The broader monetary aggregates — M2 and M3 — have thus come to the fore as the principal targets of Federal Reserve policy, at least for the time being. Of the two, M2 has always been given greater emphasis by the Fed. Unfortunately, M2 is an elusive monetary policy target because so little is understood about the factors that influence its growth. And since M2 comprises four-fifths of M3, the latter aggregate is equally suspect as a target for monetary policy.

One of the puzzling facts of recent financial history is the stability of M2 growth. During the period from 1978 through 1985, the growth of M2 (measured fourth quarter to fourth quarter) was between 8.0 and 9.3 percent in seven of the eight years. Only in 1983, when M2 growth soared to 12.2 percent, was the pattern of exceptionally stable M2 growth broken. In 1986, it appears that M2 growth will once again be within the 8.0 to 9.3 percent range; from the fourth quarter of 1985 through September, the annual growth rate was 8.5 percent.

What makes this stable growth rate of M2 truly remarkable is that no one planned it that way. It just happened, and it happened even though the most important determinants of M2 growth — nominal GNP and short-term market interest rates — were fluctuating wildly. Nominal GNP growth during the eight years from 1978 to 1985 ranged from a low of 3.1 percent in 1982 to a high of 14.8 percent in 1978. Three-month Treasury bill rates were as low as 6½ percent in early 1978 and as high as 15 ½ percent in the middle of 1981. But M2 growth chugged along in every year but 1983 at between an 8.0 and 9.3 percent rate.

In recent years, the Federal Reserve Board staff (and it is a first-rate staff) has been studying intensively the forces that determine the growth of M2 and the other major monetary aggregates. I am confident that they will eventually succeed in understanding these forces better than anyone does today. For the moment, however, establishing a target growth rate for M2 substantially outside the 8 to 9 percent range characteristic of recent years would be hazardous. No one could be confident of the course of monetary policy needed to achieve the desired result or what the effects would be on interest rates and GNP growth if the desired growth of M2 were actually achieved.

This is not a happy state of affairs. When monetary policy is deprived of a reliable monetary target, the monetary authorities have to fly more by the seat of their pants. The job of running monetary policy is difficult under the best of circumstances, and doubly so now.

Inflation: Steady at 3½ Percent

Phillip Cagan

Much to everyone's surprise we are doing very well on the inflation front. The consumer price index (CPI) in the third quarter of 1986 rose 2½ percent at an annual rate. This reflects 2 percent for commodities excluding fuel and energy and 4 percent for services (a welcome decline from a previously persistent 5 percent for services). The rate for all items was lower in the first two quarters only because of unsustainable declines in oil and other commodities. The employment cost index (compensation of private workers), my favorite indicator of the underlying momentum behind inflation, is down to 2¾ percent in the third quarter.

I published a book in 1979 (*Persistent Inflation*, Columbia University Press) reviewing the failure of the prior attempts of monetary policy to subdue inflation in 1966, 1969, and 1975 and, although then pessimistic about the prospects, I admonished the Federal Reserve to be more persistent in pursuit of an anti-inflationary policy. While I am too modest to take full credit for the subsequent stiffening of our policy, the inflation rate not only came down in the business recessions of 1980 and 1981-82 but, uncharacteristically, has declined further in the subsequent business expansion. We had not seen this countercyclical pattern since the inflation of the 1950s expired after the two recessions of 1958 and 1961.

An enticing explanation of why inflation has not escalated since 1982 is that gigantic budget and trade deficits came in to appreciate the dollar, which thus fortuitously reduced import prices and held down many other prices through intensified foreign competition. Now that the dollar is depreciating we could, on this explanation, face renewed inflationary pressures. While an index of import prices has indeed accelerated (the BLS import price index excluding fuels rose 7½ percent from mid-1985 to mid-1986, up from 2 percent the preceding 12 months), this has so far not led to higher inflation, allegedly because of the offsetting collapse of oil prices (the BLS import price index including fuels fell 10½ percent in the year ending mid-1986). With oil prices recovering, the economy is now supposedly poised for renewed inflation.

Phillip Cagan

"The inflation premium in bond yields should gradually decline further."

Maybe, but I am skeptical of this view. First of all, the measured depreciation of the dollar appears far larger against OECD countries than against a more comprehensive group of our trading partners, weighted for bilateral trade or for multilateral trade to allow for third-country competition, and even in real terms to allow for relative inflation rates. Moreover, the depreciation of the dollar does not tell us how foreign competition has affected price decisions and profit margins.

To check on prices in industries especially subject to foreign competition, I constructed a price index based on 4-digit SIC manufacturing industries in which imports and exports were a quarter or more of the market and for which the BLS publishes an index of selling prices. Since 1979, as the dollar appreciated, the index I constructed rose 7 percent less than an index for all commodities excluding fuel and power (only

about 1 percent per year less). Since early 1985 it has remained 7 percent lower, despite the depreciation of the dollar. A similar comparison of wages shows no differential at all between foreign-competing and all industries since 1979. All of this indicates that profit margins rather than prices have absorbed most of the changes in the dollar.

If the dollar depreciation overshoots, as it may soon do given the lags in adjustment involved, it no doubt will have some intermediate-term effect on inflation. Also, fluctuations in commodities, particularly petroleum, will have short-term effects. But wage advances are weak and growth in unit labor costs is steady and could decline further. Consequently, the inflation rate is on a stable path of 3½ percent or so, and will probably continue at about this rate through 1987.

Long-term bond yields of 8 to 10 percent remain at levels relative to short rates that protect against rates of inflation over the long run of 5 to 7 percent. The inflation premium in bond yields has declined irregularly since 1980 as skeptical market expectations have been won over by the progress against inflation, and they should gradually decline further.

The Labor Market in 1987

Arnold R. Weber

The labor market will continue to be a source of stability and moderation in 1987. This will be an extension of the trends that emerged in 1981-82, which dramatically reversed the situation that had developed during the 1970s.

Wages and compensation continued to moderate in 1986 and there shouldn't be any significant change in 1987. The increase in average hourly earnings for workers in the private sector is running at an annual rate of 3.3 percent, down from 4.5 percent in 1985. The advance in the employment cost index for private-nonfarm workers is down to 3.8 percent, from 4.7 percent last year.

There has not been too much difference between wage gains in manufacturing (3.4 percent increases) and nonmanufacturing (3.9 percent). Increases for union members, however, have been running significantly lower (2.5 percent) than for non-union workers (4.2 percent). The only significant wage pressure is found in the public sector, in state and local government, where for the past two years wage increases have been running at 5.5 percent, reflecting a combination of the economic comeback of governments and union strength.

Productivity increases are running at a disappointing 1 percent. Thus unit labor costs will increase about 2 percent, or even less, depending upon what happens to aggregate output.

There seems to be nothing on the horizon that would dramatically alter this situation. Unions continue to be in an extended, if not indefinite, period of debilitation. The bargaining calendar poses no major threats. Indeed, some of the more generous settlements are behind us, such as communications and railroads. There has been a breakdown of some traditional bargaining structures, in particular fewer industry-wide settlements. There has also been a shift to contingent increases through bonuses and other forms of gain-sharing.

By almost all measures, the labor market continues to have significant slack and is thus unlikely to exert upward pressure on wages or to create important bottlenecks. The overall unemployment rate is stuck at around 7 percent. The median period of unemployment has stayed at 15 weeks. Overtime in manufacturing is stable at 3.5 hours. Participation rates continue to increase. In view of these conditions and the prognosis for restrained growth, the economy is unlikely to experience strong demand for labor during the year ahead.

Arnold R. Weber

"The bargaining calendar poses no major threats."

The only potential shadows on this picture are an upsurge in inflation and a significant increase in protectionism. In the absence of such developments, wage increases will be between 3.5 and 4 percent and unemployment between 7 and 7.5 percent in 1987.

The International Economy

Robert D. Hormats

Developments in the world economy next year will have a major impact on growth prospects for the U.S. economy. Virtually all forecasts of higher U.S. growth in 1987 are predicated on the assumption that this country's trade balance will improve considerably. Some improvement is, in fact, likely — a reduction in the U.S. trade deficit of roughly $30 billion in 1987 compared with 1986. That, however, will be disappointing to those who have placed great store in major improvements as the result of the decline in the dollar and will still leave American trade and current account deficits at well over $100 billion.

The major part of the improvement in the U.S. trade balance will come as the result of an increase in import prices (up roughly 15 percent in 1986 from 1985, excluding oil) thus expanding domestic marketing opportunities for American-made goods, and a decline in U.S. export prices of nearly 2 percent from 1985, thus improving prospects for sales of U.S. goods not only in Europe and Japan but also, and very importantly, in third country markets.

Unfortunately, however, at least a portion of the competitive benefits of the lower dollar will be offset by slow or only moderate growth in this country's key trading partners. Japan is experiencing difficulty in generating domestic demand sufficient to offset the reduction in profits and exports resulting from the sharp strengthening of the yen. The degree to which the recent cut in Japan's discount rate and announced fiscal stimulus will generate additional growth remains to be seen. But most evidence suggests that they will not be able to prevent an export-led slowdown—to a shade over 2.5 percent growth—in 1987.

Growth in Western Europe appears likely to be somewhat stronger than that of Japan in 1987 assuming continued vigor in the French, German, and Italian economies — all of which have performed well in 1986. The central role of the German economy in Western Europe will focus the limelight on the policies of the Bundesbank (particularly its willingness to cut the discount rate if growth should falter) and of the Federal Government (which appears prepared to move the tax cut now planned for 1988 up to mid-1987). German, French and Italian growth rates all appear headed for the 3-plus percent range. The British economy continues to benefit from considerable liquidity, strong consumer demand, and growing investment — but concerns about an uptick in inflation owing to a rapid increase in the money supply, the fall in sterling and higher wages cloud the horizon and point to growth of a bit below 3 percent.

Canada appears poised to continue its above 3 percent growth next year despite weak commodity and energy prices, but these same factors have been offset in part by increases in consumer purchasing power, stabilization of inflation, lower interest rates and the decline of the Canadian dollar relative to Japan and much of Western Europe.

Robert Hormats

"Capital flows from abroad seem likely to continue."

The developing countries present a mixed picture. Growth is likely to remain strong in South Korea and pick up in the currently lagging South East Asian economies; but much of this growth will be export led and thus will be reflected in the still large U.S. trade deficit with such countries. In Latin America, Brazil and Argentina are likely to enjoy strong growth, but most of the rest of the continent will continue to experience poor economic conditions — maintaining its strong emphasis on limiting import demand and boosting exports, particularly to the U.S.

The impact of past currency fluctuations and anticipated changes in foreign demand will be major swing factors in determining the U.S. trade balance next year and thus a significant determinant in the U.S. growth outlook. But there will be structural factors that will slow the benefits to the U.S. economy. First, the U.S. economy has over the years developed a larger marginal propensity to import — particularly consumer goods. Thus we tend to increase imports of foreign goods more rapidly at a given rate of growth now than in the past and reduc-

tions in the dollar's exchange rate do not discourage imports as quickly today as in past years. Second, markets for America's once robust agricultural exports have weakened, because of foreign subsidies and success in approaching self sufficiency by heretofore large markets such as China and India. Third, Latin American demand remains severely constrained by debt-related constraints on imports. Finally, the dollar has declined against only a handful of currencies, and has stayed about even with or risen against the currencies of many, including large U.S. trading partners such as Canada and Korea.

Assuming that U.S. trade and current account imbalances remain large, the build-up of U.S. external debt will continue along with its potentially troubling consequences. Given the depth of the U.S. capital market, the country can clearly absorb large amounts of foreign capital; and investments in the U.S. still account for less than 10 percent of total foreign savings. The issue then is not so much whether foreign exporters will invest in U.S. securities but on what terms. In recent years the positive yield differentials on U.S. bonds and other securities along with a steadily improving inflationary picture and political continuity have attracted capital from abroad even in the face of a falling dollar. But there may well be times when apprehensions about a further dollar decline, an uptick in inflation, or discontinuity of policy in the White House, Congress, Treasury or Fed will cause foreign investors to withhold, if only for a time, their capital flows to the U.S., thereby pushing up interest rates in the U.S. and weakening the growth outlook.

Increasingly the U.S. will have to pay attention to the new reality of dependence of its capital market on inflows of foreign funds. The timing of Secretary Baker's agreement with Japanese Finance Minister Miyazawa was important in reassuring Japanese investors that they could buy Treasury bonds in the latest refunding without being excessively concerned about a further decline. In the future, foreign investors are likely to continue to seek reassurance regarding currency stability. And there will be domestic policy implications. The Fed, for example, could find its flexibility to cut interest rates reduced, were the dollar to fall further and in so doing increase inflationary concerns. Likewise, were other countries to grow more rapidly and absorb a larger share of the capital that now must be exported, without a reduction in U.S. domestic borrowing requirements and with the Federal deficit remaining high, U.S. government borrowing could crowd out private sector borrowing in this country.

In the final analysis the international economy appears likely to remain relatively stable in the coming year and flows of capital from abroad seem likely to continue — barring any unforeseen departure from the current courses of policy in the U.S., or suppliers of capital such as Japan and Germany — although uncertainty as to timing and magnitude will continue as well.

The U.S. Trade Deficit Outlook

Eric J. Kruger

All eyes are currently on the U.S. trade deficit. For months, trade flows have hardly seemed to respond at all to the decline of the dollar. Hopes for a contracting trade deficit in response to a declining dollar were unrealistically high. Now, the monthly trade figures, which are often vastly deceptive, have finally shown an improvement over the past two months. Will a third month of good news herald the positive, downward trend in the trade deficit that would make the drain on the U.S. economy a little easier to bear? If the trade deficit, currently about $170 billion, does decline, this might well contribute to a quickening of U.S. economic growth. The Department of Commerce estimates that the growing scale of the trade deficit, and its pace, reduced real GNP growth by between 0.8 and 1.9 percentage points from 1980 to 1985, and by 2.5 percentage points in the latter part of 1985. This is one relationship that we can expect to work in reverse: Fewer imports and more exports generally lead to solid growth.

Yet there are three problems with this outlook. The first is the real danger that we are perceiving the cause of fewer imports in reverse. The slowdown in the U.S. economy may be becoming at least as important a factor in reducing imports as the lower dollar. Moreover, slowing growth in all but a few of the United States' major trading partners, notably Japan, may also be dampening exports. (Japan now absorbs 11 percent of U.S. exports, but its purchases from the U.S. fell by 3.6 percent from the second to the third quarter.) The trade deficit could continue to fall, but it may be because imports contract faster than exports. That would not indicate what analysts have been hoping for—a healthy increase in competitiveness and an exchange-rate advantage. Furthermore, it is

Eric J. Kruger
"In Congress, stronger protectionist initiatives are coming, with retaliation overseas."

hard to tell at this stage whether this kind of improvement in the trade deficit will offset the extremely sluggish U.S. economy, considering the time needed for such an effect to manifest itself.

Second, the Democrats' return to power in Congress will mean stronger protectionist initiatives, with retaliation overseas. Many industries, both basic and high-tech, have seen rival imports continue to grow and their own exports perform poorly. Across-the-board protectionist initiatives may have been allayed by the lower dollar and recent news of a shrinking trade deficit; pressures from specific industries have not.

The third question mark is the impact of U.S. tax reform and protectionism on foreign capital flows. Tax reform is already attracting attention around the world as promising to expand the domestic market through its effect on net disposable income. It also offers to increase the overall after-tax profit rate (relative to that obtainable elsewhere), even with the abatement of benefits on capital investment. The threat of a resurgence in U.S. protectionism for manufacturing will also increase the flow of foreign investment to that industry. This is likely to put renewed pressure on the dollar, if not in 1986, then in 1987 and 1988, with a dampening effect on U.S. trade prospects.

An increase in foreign investment after tax reform might not have the full multiplier impact on the trade deficit, if at the same time domestic consumption is contracting in those markets. This is because there will be some crowding-out of both foreign and domestic manufacturers. Such a trend is already visible in the automobile industry.

My outlook calls for the trade deficit to reach $170 billion in 1986, a moderate reduction of that deficit in 1987 to about $150 billion, the possibility of renewed pressures on the dollar, and the real possibility of protectionist initiatives. Interestingly, in the longer term, U.S. tax reform provisions and foreign capital inflows specifically devoted to manufacturing should yield fewer imports (of final goods) and more U.S.-made and foreign-made competitive exports. The trade deficit may thus shrink, not for the reasons we may have expected, but because demand in the U.S. and in several of its trading partners is contracting. And it may continue to shrink more from tax reform and protectionism than for any concerted policy action on the dollar.

Consumption and Housing

Roger E. Brinner

The latest round of automobile financing incentives was an enormous hit with both consumers and auto dealers. Retail sales soared in September and what otherwise would have been an unremarkable quarter for consumer spending became the strongest performance since early 1983.

The 7.2 percent third-quarter gain in real spending is unsustainable, however. Automobile financing pushed consumer installment debt to 19.6 percent of income, and the surge in consumption pushed the saving rate below 2 percent for the first time on record. Disposable income must now catch up with spending and debt. Since few signs point to any major gains in income before the first phase of tax reform in January, even non-automotive consumer spending is unlikely to regisiter any significant advance between now and the end of the year.

The impressive consumer spending gains recorded thus far in 1986 vastly overstate the strength of the underlying market fundamentals. Plunging energy prices, generous auto financing terms, and surging stock prices all played to the consumers' advantage, but neither the general economy nor the consumer sector can count on a repeat of these favorable events.

A review of the major determinants of consumer spending suggests that although consumption growth will lag behind that of the general economy, it is unlikely to induce a major downturn. With only modest improvement in unemployment and unchanged average weekly hours, an expected increase of 2 percent in total employment and a 3.4 percent rise in hourly earnings will keep income growth near 6 percent for the next three years. Disposable income will, however, get a boost from tax reform, which shifts $120 billion in taxes from consumers to business. Inflation will run close to 4 percent, however, so that even with the personal tax cut, real income growth will be hard-pressed to exceed 2 percent during the next three years.

Roger E. Brinner
"Spending growth will slow throughout the year."

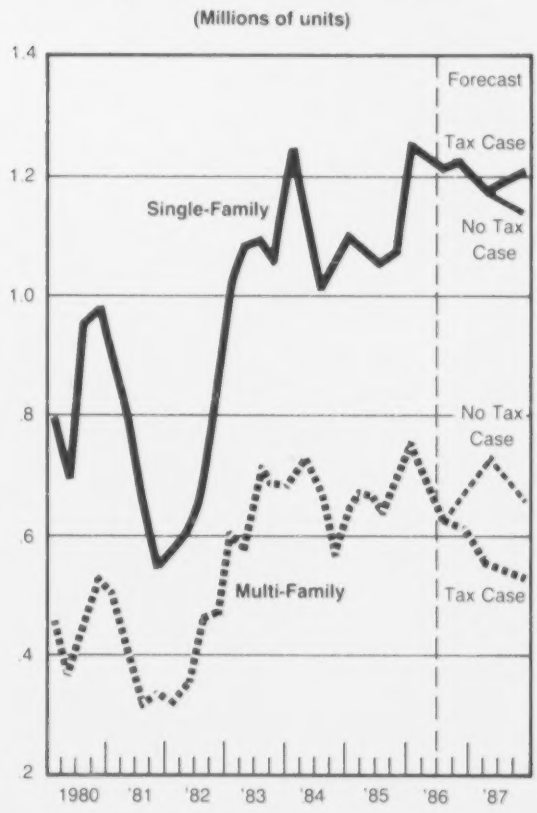
While before-tax interest rates will continue to fall, the phase-out of the deduction of interest on consumer loans and lower marginal tax rates will tend to increase both the consumers' after-tax cost of debt and the return on financial assets. Thus, net consumer debt acquisition will slow throughout the forecast period.

The sharp rise in stock prices during late 1985 and early 1986 raised household assets faster than liabilities, despite the continued runup in consumer debt. Over the next three years,

Real Personal Consumption Expenditures

	1985 Actual	1986 Est.	1987 Forecast
Total Personal Consumption	3.5	3.9	2.2
Personal Consumption except Autos and Parts	3.2	4.0	2.2
Durable Goods	7.8	5.5	2.1
Autos & Parts	7.3	2.4	1.8
Furniture & Appliances	8.3	9.7	2.0
Other Durable Goods	8.3	4.8	3.4
Nondurable Goods	1.6	3.7	1.3
Food & Beverages	2.2	1.8	0.7
Clothing & Shoes	2.3	7.1	2.5
Gasoline & Oil	0.4	8.3	2.0
Fuel Oil & Coal	-8.7	7.7	0.9
Other Nondurable Goods	1.1	2.5	1.3
Services	3.7	3.5	2.9
Housing	2.6	2.5	2.8
Household Operation	1.9	0.1	3.6
Electricity	5.1	-1.5	6.3
Natural Gas	1.6	-1.7	2.9
Other	-0.2	1.9	1.9
Transportation	6.7	5.5	6.5
Medical	3.0	3.5	3.2
Other Services	5.3	5.6	1.4
Real Consumption	64.8	65.6	65.4
As Percent of Real GNP			
Per Capita ($)	9709	9993	10117
Saving Rate (NIPA Basis, %)	5.1	[illegible]	4.1
Retail Sales (Billion $)	1372.5	1439.3	[illegible]
Percent Change	6.4	4.9	[illegible]
Real Disposable Income (%Ch)	2.3	3.2	2.1
Civilian Unemployment Rate (%)	7.2	7.0	6.8
Consumer Sentiment Index (1966/I = 100.0)	93.2	94.2	92.9
Real Household Financial Assets (%Ch)	13.0	9.1	3.8
Installment Credit Outstanding (%Ch)	18.8	13.7	7.5
Credit Outstanding as % Disp. Income	17.8	19.3	19.6

Impact of Tax Reform on Housing Starts



however, real household net worth will grow only 1 percent annually and thus provide little support for consumption.

Falling energy prices and rising stock prices pushed the University of Michigan's Index of Consumer Sentiment to 99.3 early this year, its highest value in two years. While this index was down to 91.9 by September, consumers remain unusually optimistic for this stage of the business cycle. Attitudes will continue to drift lower during the remainder of this year before modest disposable income growth and a slowly improving unemployment rate early next year reverse the tide.

Real consumer expenditures are expected to decline at an annual rate of 3.9 percent during the fourth quarter as spending for motor vehicles and parts drops from its third-quarter peak. The impending cut in personal tax rates will then raise real disposable income 4.8 percent in the first quarter of 1987, fueling a minor rebound in consumer spending. With lackluster income growth thereafter, spending growth slows throughout the year. On a fourth-quarter over fourth-quarter basis, real consumer spending rises 3.2 percent in 1986, but the gain slows to 2.6 percent in 1987. (See table for detailed forecast.)

Housing

Having fallen in four of the past five months, housing starts have finally dropped below what the market can absorb. The current 1.68 million unit annual rate is expected to improve in the coming months, bringing the average for the next four quarters up to 1.73 million units. As mortgage rates settle near 10 percent, single-family starts should remain between 1.15 and 1.20 million units (annual rate) through 1988.

Multi-family starts, in contrast, would decline by 250,000 units from their peak in the first quarter of 1986 to the fourth quarter of 1988 as the market absorbs excess capacity and responds to the new tax laws (see chart). Overall, new residential construction should slide from 1.86 million units this year to an average 1.69 million units in 1987 and 1988.

Capital Goods and Inventories

Bruce R. Lippke

The economy remains on a slow but steady expansion path that seems likely to outlast any that even the oldest of us have experienced. Plant and equipment spending normally follows general economic activity with only a short lag and therefore should be experiencing a similar steady-but-slow growth path.

This recovery, however, is still complicated by dramatic restructuring. In this year's second quarter, although real GNP remained at 2.6% growth, real nonresidential investment dropped off suddenly—to 1% below the level a year earlier. But this aggregate statistic only partially reveals the turmoil affecting business planning.

In 1985 overall business investment climbed to 13 percent of GNP, compared to under 12 percent at earlier cyclical peaks. But this time the consumption share also rose to 65 percent compared to 63 percent at prior peaks. The mathematics of our twin trade and federal deficits are indeed charming, as we can invest in the future and consume even more simultaneously, of course paying with IOU's to the foreigners as we use their goods and capital instead of our own. But those problems plague only the longer term forecaster.

The early 1986 air pocket that hit capital spending was primarily triggered by the drop in oil prices. The resulting cash constraints for energy investors produced a 40 percent decline in petroleum-related investment. Then the added new dimension of tax reform comes along, with the effect of imposing a reduction in cash flow that restricts the cash available for investment by many firms. This negative development has replaced the oil-cost savings that otherwise would have been neutral to positive for investment by energy-using industries over the longer term. Thus, the decline in investment, although triggered by the petroleum sector price collapse, has been solidified by the tax reform impact. The distributional effects are wide, with some sectors losing from both the oil price collapse and tax reform and others gaining from both.

It is plausible, however, to conclude that most or all the negatives for business investment from both the oil price decline and tax reform are already behind us. This is easy to imagine for the energy sector in view of the very sharp decline that took place in mid-1986. In addition, it seems likely that the enormous shifts in wealth caused by tax reform were discounted well before passage of the legislation. Furthermore, anecdotal evidence also suggests that the investment decline is mostly over and there will be increases in late 1986, strengthening in 1987.

- *Oil related*: U.S. drilling-rig activity bottomed out in the summer and will increase by 20 percent if crude prices move up from $14 to $18. New orders are again being placed for oil and gas casings and other pipeline stock, after what has been called a zero order year.

Bruce R. Lippke
"Difficult to write a recession scenario."

- *Office equipment*: New orders for office equipment and computers have rebounded from their early 1986 collapse and in real dollars are back above a 15 percent trend growth line. Nominal growth of 10 percent and real growth of 20 percent is plausible for 1987.

- *Auto machinery related*: Lower gasoline prices are boosting truck sales. Auto plant modernization is doing better, spurred on by the Japanese-production-process revolution in the U.S. Power tool technology has spread from autos to nearly every business. Equipment orders from overseas are being received again. Commercial airplane books are strong.

- *Construction*: Power distribution equipment is responding to strong residential demand. Shopping-center growth will continue as one element of strength in the otherwise disastrous commercial building sector.

- *Defense related*: While defense contractors are being hit by both a slowdown in defense spending and tax reform, so far at least it looks like they will fall back to a normal contribution to spending growth rather than becoming a big negative quickly.

Inventories

In theory, we should expect to see stable inventory growth flowing from our stable final sales trend. Actually, the change in inventory investment exceeded sales in 1984, as a catch-up from the 1982 runoff, and have fallen short of the sustained sales rate in 1985 and 1986. This has produced record low inventory-to-sales ratios. In 1987 inventories should contribute to aggregate growth even though managers are working harder than one would expect (given that interest rates are down and final sales growing) to keep inventories under control.

Against that backdrop there are the inventory anomalies, such as the sharp rundown of auto inventories in September—perhaps $22 billion at annual rates—with most of it being restored by November. Another is the oil inventory mystery. Imports are high and prices low, with OPEC production running at a considerable surplus. But the math can't be easily balanced, as the inventories are not to be found. Some of the U.S. consumption increase may actually represent an increase in user inventories.

Summary

Business investment will decline a modest 1 percent in 1986 and recover by at least 1 percent in 1987. The anecdotal evidence seems stronger than our model-driven forecast, which we could easily decide to strengthen after further review. In inventories, there is no risk of a major run-off and, in fact, there is room for some increase, since market-share battles are typically very tough in a slow but growing market.

While this business cycle expansion is on borrowed time compared to history, it has been slow enough worldwide that it lacks any of the characteristics of overheating that produce recessions. The capital spending and inventory prospects described here make it difficult to write a recession scenario for 1987 or 1988.

Credit Markets

Robert G. Dederick

An old economic maxim tells us that anyone bold enough to accept an offer to forecast the outlook for interest rates, should be asked to return the invitation immediately. He obviously is not smart enough to be trusted with the job.

Regretfully, that sage observation is even more true today than when first articulated by Adam Smith—or was it Groucho Marx? A look at just some of the determinants of interest rates indicates the magnitude of the forecasting problem.

• *The business outlook is uncertain.* With both pluses and minuses at work (in the latter case including, for the record, a less easy fiscal policy), the most prudent forecast—the one least likely to leave the perpetrator badly exposed to error—seems to call for economic growth in the 3 percent neighborhood over the course of 1987. But from this razor's edge pace, a deviation of only one percentage point either way would have markedly different interest rate implications—far different than if the presumed central tendency were, say, 5 percent or 1 percent. And the chances of such deviations occurring are quite high, given the key role that the essentially unpredictable trade balance is asked to play in the forecast. To make matters worse, even if the 3 percent estimate turns out to be correct, there is this little question to consider: Will such a feat be accomplished without help or will it require *lower* interest rates? —or, less likely, will it occur in spite of *higher* interest rates?

• *Market attitudes toward inflation prospects are uncertain.* It is hard enough to predict the inflation rate, but to predict what the market will be predicting for the inflation rate is a task best left to the late Mr. Keynes. Will marketeers be satisfied that inflation is "under control"—as was the case early this year, when oil prices were declining—or will they be worried that an outbreak lies ahead—as has been true more recently, when attention has been directed to the price pressures destined to emanate from the "inevitable" reduction of the trade deficit (and the "inevitable" further fall in the dollar required to bring about this reduction)?

Robert G. Dederick
"One more window of opportunity for short rates."

• *The impact of tax reform is uncertain.* We can be confident that anything as far reaching as the 1986 tax reform has implications for interest rates—both directly and via its impact on the strength of the economy, and also through both its macro and its micro features. But we cannot be confident we know what these implications really are. By the time we achieve the required threshold of knowledge, chances are that the effects already will have been felt. Indeed, some of them probably have been felt by now.

• *Monetary policy prospects are uncertain.* Ignorance of prospective monetary policy is something we accept as a fact of life—it goes with the forecaster's territory. But this ignorance is especially pronounced when we consider (a) the changed makeup of the (increasingly Reaganized but otherwise diverse) Federal Reserve Board membership, (b) the manifold goals (Satisfactory growth, inflation control, orderly foreign exchange markets, financial stability) that the team is trying to achieve in today's ambiguous (and financially fragile) world, and (c) the variegated indicators to which the members look for guidance (including, but not confined to, commodity prices, the dollar exchange rate, several monetary aggregates, the shape of the yield curve, and interest rates across the sea). And the fact that Chairman Volcker's term is scheduled to expire next August adds further spice to the uncertainty.

But, enough! The truth in labeling requirements have been met. Now for the forecast to which they have been—no doubt fruitlessly—attached.

With the economy still not clearly launched on the long-predicted, long-awaited, and long-postponed solid growth trajectory, the odds are that the window of opportunity for lower short-maturity interest rates will be opened, and utilized, at least one more time. Indeed, it appears to be open at present in consequence of Japan's recent discount rate cut. The monetary policymakers' concern about near-term recession—with its adverse implications for reasonably free trade, the Federal budget deficit, and financial stability here and abroad—will override their concern about later term inflation.

But, with marketeers holding to a more far out view (to be interpreted as one sees fit) the odds also are that longer-maturity rates will fail to take the downward cue and instead will meander along a flatter path—moving to one side or the other in accordance with the latest readings of Japanese investors' intentions, dollar exchange rate prospects, commodity futures prices, and so forth.

Thereafter, short rates are likely to stabilize as the Fed seeks to maintain its anti-inflation credentials, while long rates could well rise somewhat as the market looks ahead to higher short rates down the road (with tax reform having little net macro effect in either area). Assuming, though, that the economy holds close to a 3 percent growth incline, a sharp upswing in bond yields probably will be avoided in 1987. Even in today's brave new financial world, expectations still can carry markets only so far.

The Equity Markets

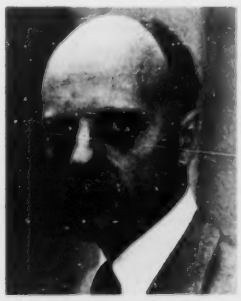
Robert H. Buckles

From roughly August 1982 to August of this year we have had a pheonomenal bull market in U.S. equities. We have gone very far very fast, and signs of distribution and industry rotation began to appear this spring at roughly the same time the long government bond stumbled in its tremendous advance and began waffling. Since most of this bull market—particularly over the past two years—has resulted from multiple expansion rather than an increase in corporate earnings, it seems more than sheer coincidence that the multiple expansion stopped at roughly the same time that the improvement in interest rates ended.

Once again we are at a point where the market is pausing to see whether we are still in a disinflationary, multiple-driven stock market or whether we are shifting to a period when the economy improves. With an economic improvement we would have an increase in corporate earnings to drive the market, although perhaps at the expense of a couple of price earnings multiple points.

Since early summer we have been suggesting that the transition from a multiple-driven to an earnings-driven stock market is not necessarily a smooth one if, indeed, this transition takes place at all. Moreover, there would appear to be more room for a fall if one slips in making this transition, just after we have had an historically strong four-year bull market, than if there had been more modest gains in the market. Markets where price-earnings multiples have expanded rapidly are less forgiving.

As a consequence, we would continue to look for a correction in the stock market in one of two forms: (a) a sharp correction of 10 percent to 15 percent from its highs of this past summer, or (b) in the form of recurring rotation among industry groups in the market as it seeks to determine whether or not the economy and the economically sensitive stocks will be more attractive or whether the disinflationary scenario is



Robert H. Buckles

"Room for a third (and perhaps final?) rally."

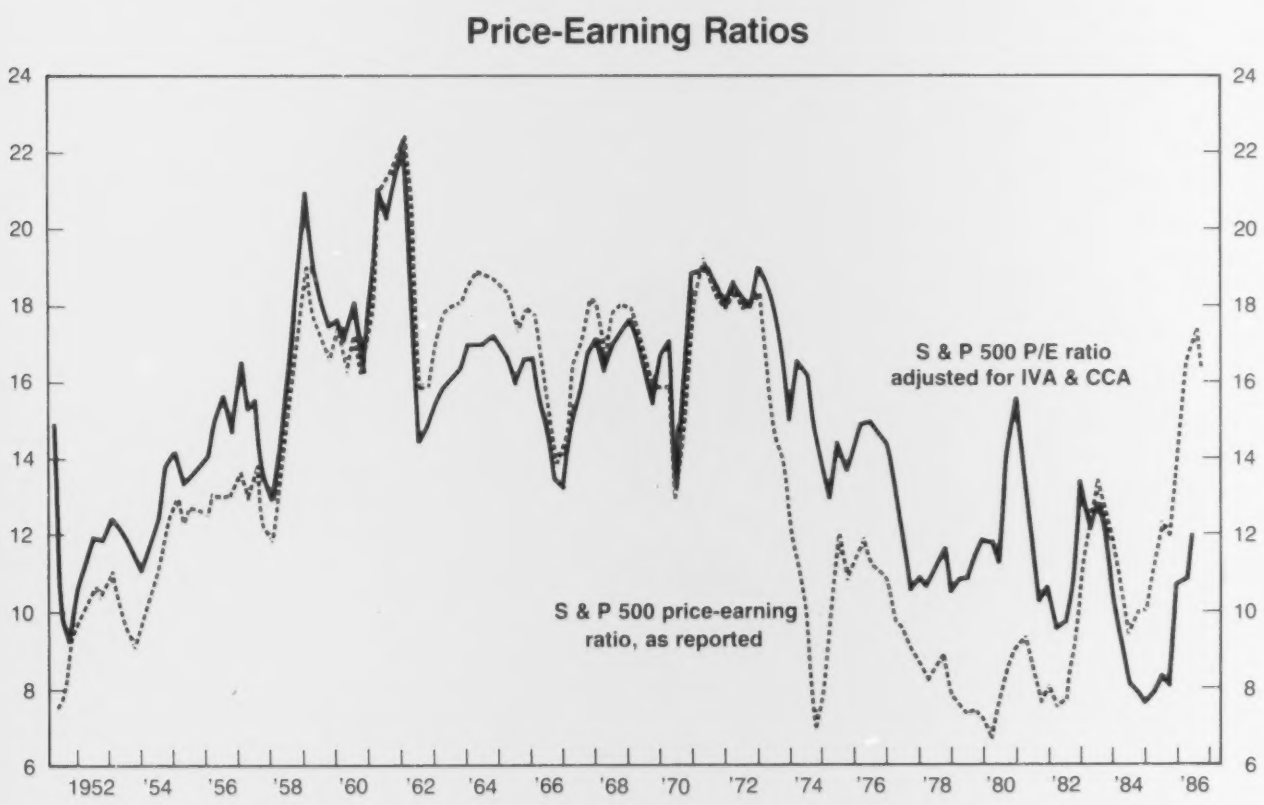
still in place. My own feeling is that we may have some of both (a) and (b) although I am more inclined towards the (b) or rotation scenario.

Where Are We Going?

Eventually, I think there is room for a third (and perhaps final?) rally in this historic bull market of the '80s. If one adjusts the sharp advance in the S&P 500 to reflect inflation or adjusts for the improvement in the quality of earnings (as is attempted in the accompanying chart), then the stock market, despite this tremendous advance from the summer of '82 to the summer of '86, still does not appear to be out of line relative to historical standards.

After the current correction that we have discusssed in the equity markets has been completed, we then see the possibility of another upward leg in the equity markets. This might occur if the economy does pick up later on and does so without causing a noticeable increase in inflation. At that time (hopefully during 1987), we might be able to experience both rising earnings and eventually even some further improvement in price-earnings ratios at the same time. This would lead to the final ascent in the stock market and complete the decade of the '80s in grand style.

We could then see that we had unwound the inflationary decade of the 1970s both in the improvement in the quality of earnings as well as in total corporate earnings coupled with an expansion in price-earnings multiples reflecting the lower levels of inflation. The decade would also be the reverse of the 1970s with financial assets once again in the ascendency, as they were for many years prior to the 70s, and tangible assets having experienced a decade of relative underperformance.



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Research Bulletin

No. 205

The Conference Board

Marketing Priorities

by Louis A. Wallis

Management Summary

- Improving profitability is marketers' top priority.
- To meet competitive challenges, companies will increasingly emphasize new products, stronger customer linkages, and other alternatives to price competition.
- Many companies' action plans will seek to boost sales force productivity and strengthen their distribution systems.

Marketing Management Research

About This Survey

This survey is based on information provided by 260 members of The Conference Board's Senior Marketing Executives Panel. The participants represent a cross-section of U.S. manufacturers encompassing both industrial and consumer product sectors. While some of the executives, located at a corporate level, reported for their entire companies, a larger number reported on their specific operating units. The panel members hold a variety of managerial titles, the most common being that of vice president of marketing.

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THE NUMBER-ONE MARKETING PRIORITY for manufacturers in the next three years will be maintaining—or, in some cases, regaining—profitability. The latest survey of The Conference Board's Senior Marketing Executives Panel, representing a cross-section of U.S. manufacturers, finds most of the 260 respondents assigning the very highest priority to profitability goals. In pursuing these goals, the marketers will focus their attention on specific competitive challenges in these main areas: developing new products and services; boosting sales and distribution productivity; and strengthening customer relationships.

For a majority, the past three years have been marked by intense price competition, heightened new-product activity, and new inroads of foreign competitors. For a majority, too, marketing has become an ever-growing concern of senior management. Table 1 describes these and other recent changes in key marketing factors cited by the reporting executives. Table 2 describes the relative priorities the marketers say will be given to various marketing challenges confronting their operations over the next three years.

Looking ahead, many managements acknowledge that some current marketing activities, and particularly their costs, will need to be curtailed in the future. Even those enjoying recent market successes confirm a need to regain full fighting trim. As the vice president of an equipment producer puts it: "You get sloppy when times are good. Many changes are really needed. Our customers are much more demanding, but that's good for us. Our products have improved and everyone is better off for it."

Improving Market Competitiveness

The biggest challenges marketers foresee reflect their expectations of a vigorous competitive environment. During the next three years, most marketers will be searching for effective answers and alternatives to price competition. In this regard, many pin their highest hopes on improved offerings to their customers—especially the results of programs aimed at raising product quality.

The task of remaining competitive against both domestic and foreign sellers will be further complicated for the one-third of the total responding who now face a larger number of direct competitors than they did three years ago. The marketing plans of manufacturers in depressed industries anticipate a scramble for shares of existing business. Not all companies will provoke head-on fights in their markets, if these can be avoided. An electronic components company, for one, intends to develop "nonconfrontational market strategies" with respect to its adversaries, large Japanese and domestic manufacturers.

In some cases, a lack of solid marketing information hampers competitive response. A substantial number of firms will be working to improve the quality of their marketing-information and competitive-intelligence systems. Among those that already benefit from such action is a rubber company. According to its chief marketing executive: "The combination of solid market intelligence and good strategic planning has enabled the growth of our business in the areas we have identified for growth." Similarly, a manufacturer of scientific instruments attributes a 15 point gain in market share to better identification of the firm's customers by market segment.

Fundamental changes in the character of the competition facing some manufacturers pose special threats in the period immediately ahead. For example, one company has traditionally manufactured parts for assembly into complete products by its customers. Now the competitive offerings of foreign suppliers embody not just the parts themselves, but entire product assemblies or large subassemblies. This may eventually force the U.S. producer to take the costly step of forward integration in order to remain competitive.

The marketing vice president of a consumer appliance company notes the growing power of domestic retail chains, which not only forces readjustments by their suppliers but often renders traditional marketing practices uneconomical. In selling to large U.S. retailers, his company competes against Far Eastern manufacturers that have no marketing organizations and few marketing expenses in the United States, since they maintain no stateside inventories or receivables. With a selling structure that is costly by comparison, the U.S. company was compelled to offer unattractive prices to its retailer customers. Attacking the problem from the production side, the manufacturer has begun sourcing components—and even complete products—overseas, thus regaining sufficient cost advantage to support more adequate margins. The company is also de-

veloping new products and product variations to offset temptations for its retail-chain customers to rely on offshore suppliers.

A few managements are resorting to outside help in their attempts to remain competitive. With the assistance of consultants, one capital equipment manufacturer has managed to reduce its manufacturing costs by 35 percent and thereby to maintain leadership in its field.

Occasionally, manufacturers are planning—or have already undertaken—a major restructuring of their marketing operations in preparation for future marketing wars. To take better advantage of its global strength, one firm restructured its product manager system, better enabling it to counter competitive moves worldwide. Another, in preparation for a substantial reorganization, retrained 400 managers in a new program designed to help them to identify critical competitive situations and to rethink their marketing missions.

Developing New Products and Services

Generating new-product ideas is another high-priority mission. For most companies, this follows a period of increased new-product introductions and greater dependence on new products. Among others, a food company has already installed "a systematic new-product process that encourages creativity and risk taking, while assessing which new-product opportunities to pursue." A commonly described search is for product niches offering greater market leverage, as well as for new-product entries with demonstrable advantages—for example, cost-effectiveness—to the customer.

The "new" in new products is being redefined in many cases. New just for the sake of newness is no longer enough. Instead, managements are seeking a more precise targeting of new-product programs. Although four out of five marketing operations in the survey increased the number of their product lines during the last three years, several now propose what one executive describes as "intense concentration on core products, rather than diffusion through diversification." Others, like a producer of industrial components, will place heaviest emphasis on "demonstrable product differences."

Two different approaches to stimulating new-product advances illustrate the range of methods, from dependence on technical creativity to the application of straightforward mar-

Table 1: Changes in Key Marketing Factors in Past Three Years[1]

Key marketing factors	Percent of 260 executives reporting[2]		
	Increase	Decrease	No change
Intensity of price competition	83	0	17
Senior management concern for marketing	66	3	31
New product introductions	59	5	36
Impact of foreign competition	56	2	42
New markets—internally generated	50	2	49
Dependence on new products	49	5	46
Number of line extensions	41	6	54
Number of product lines	40	12	49
Intensity of nonprice competition	37	6	57
Number of direct competitors	36	11	53
Number of items within product lines	35	11	53
Support for dealers and distributors	35	8	57
Markets entered by acquisition	30	2	69
Advertising and sales promotion costs as percent of total marketing costs	29	22	50
Marketing costs as percent of sales	27	16	57
Company's sales in foreign markets	19	13	68
Number of distribution channels	17	7	76
Dependence on direct sales	17	9	75
Markets relinquished by divestiture	6	7	88

[1]Reported changes in factors listed on questionnaire.
[2]Rows may not total 100% because of rounding.

Table 2: Marketing Priorities for Next Three Years[1]

Marketing priorities	Percent of 260 executives reporting[2] Highest priority				Lowest priority
Profitability	68	25	6	1	0
Alternatives to price competition	54	27	15	3	1
Product quality	51	26	16	5	1
Sales force's productivity	49	41	7	2	0
Better communication with customers	45	39	15	1	0
Price competition	40	36	16	6	2
Generating new-product ideas	39	34	19	5	2
Emphasis on long-term strategy	35	38	20	7	1
National account programs	29	30	25	10	6
Adding new products or services	28	42	18	8	4
Exploiting new market segments	28	43	21	6	2
Strengthening distribution channels	27	40	21	8	4
Training and development	27	36	27	9	1
Better marketing information systems	25	46	23	5	1
Marketing cost-control	22	37	34	6	0
Competitive intelligence	21	43	28	7	2
Expand or diversify by acquisitions	20	27	18	18	18
Better internal communications	19	44	28	8	2
Technical and service support	17	36	31	13	3
Support for dealers/distributors	16	32	25	17	10
Management development	16	36	31	14	3
Reducing new-product risks	16	25	39	13	8
Emphasis on short-term tactics	15	36	34	14	1
Increasing foreign market sales	15	31	18	15	21
New distribution channels	14	19	26	25	16
Reorganizing sales force	14	27	25	22	12
Line extensions	13	35	27	20	6
Improving physical distribution	13	26	31	18	11
Reorganizing marketing staff	11	28	30	20	11
Reducing dependence on market segments	10	27	40	14	9
Market measurement and research	10	28	38	18	5
Sales promotion and merchandising	10	24	37	22	6
Increasing reliance on computers	8	40	33	14	5
Advertising support	8	24	41	20	7
Deleting products or services	7	21	37	22	12
Telemarketing capabilities	7	20	27	21	25

[1] Executives reported the relative priority of each item on a five-point scale, from highest to lowest.

[2] Rows may not total 100% because of rounding.

keting expertise! An R&D breakthrough allowed one electrical equipment company to manufacture a basic component of its products in a way that cuts costs and improves performance. With further development of a new process to produce the new material and field tests confirming performance superiorities as well, the company plans to reap a competitive advantage. By paying attention to basic marketing skills such as marketing research and market testing, a producer of consumer textile products netted a significant sales increase by simply revamping its product lines and offering several new products.

In some cases, new-product success is resulting from early involvement of customers in the product-design process. One company, following this approach, developed a new component providing benefits of superior performance, lighter weight, and lower cost. The supplier's application engineers now meet regularly with customer counterparts to discuss upcoming opportunities for new products.

Some marketers are addressing their need for speeded-up and better targeted R&D efforts. "Because of the shortened life expectancy of our products," reports the vice president of one industrial products manufacturer, "R&D must have replacements sooner. Commercialization must be done more quickly." With this in mind, some firms are taking pains to strengthen the linkage between marketing and R&D. In the case of a chemical producer, for example: "All segments of our company are now market driven. Production and R&D are no longer on the sidelines. More application work is done in our labs."

Sales and Distribution Productivity

Managements in most responding companies will employ a variety of means in the next three years to ensure greater productivity of their sales forces. For example, national account programs, aimed at serving a company's most important customers, will rate high priority. Most manufacturers will also be working to strengthen existing distribution channels, rather than adding new ones.

A maker of industrial equipment, isolated from the ultimate users of its products by intervening distribution channels, is one of several firms taking steps to get better information from the field for planning its programs. Its marketing director says: "In taking a more active interest in distribution to the end user, whether industrial, retail or contractor, we become more aware of how our products are used. This leads to a broadening of our product lines."

Apart from other actions contemplated (or in progress) for improving their selling capability, over 10 percent of the surveyed manufacturers have recently taken the step of reorganizing their sales organizations in some way. Their objectives and solutions differ widely. Some have moved toward greater consolidation of their forces, while others were shifting in the opposite direction. Recent periods of depressed sales have led a few companies to reassign some of their sales personnel to product-service positions.

[1]For a reporting on how the commercial development function in some companies contributes to new product development, see Michael G. Duerr, *The Commercial Development of New Products*, The Conference Board, Report No. 890.

Strengthening Customer Relationships

While one of the executives suggests that customer loyalty may be a remnant of former times, the hope of generating such loyalty—or, even more often, of becoming an indispensable supplier—is a widespread, high-priority goal among the reporting manufacturers.

A few have recently gone to exceptional lengths to keep valued customers happy. A chemical company's vice president of marketing reports: "One of our good customers needed a product we didn't make, formerly supplied by a competitor that dropped the line. We set up a manufacturing facility to make that product because we were dedicated to that customer. We have to take the bad with the good in this industry."

Other manufacturers, however, are reaching the profitable limits of certain service offerings. One, for example, has been incurring high costs when performing pre-sale development and applications work for its prospective customers. A spokesman reports that, unfortunately, it is difficult to get paid for that work. On occasion, a prospect benefitting from this consultative help has then turned to a competing supplier to purchase a similar product at a lower price. Such experiences are causing management's reconsideration of this company's consulting service program.

A changing customer base is jeopardizing future market prospects for still other firms. Says one executive: "We are approaching a point where there will be no small customers and no small competitors. Until that process is completed, we must be prepared to endure erratic market behavior by customers and competitors alike struggling in a survival mode."

A group vice president of another industrial products company voices a common concern about "the continued retrenchment of U.S. industry. The consolidation that will take place will put extreme pressure on suppliers. The resulting overcapacity, price pressure, and elimination of outlets will be difficult to deal with."

Most executives, however, remain upbeat in viewing the future, with their optimism often based in part on their companies' plans for developing closer, more productive relationships with their customers. A typical explanation is that of an equipment company's marketing vice president: "We are looking for relationships, not transactions." Other executives refer variously to hopes of becoming a "team player with the customer" or of building a "customer partnership to parallel component and system development." The challenge, in the words of yet another, is "meeting the quality, price and delivery targets of customers who want world class suppliers."

"Value added" is said to be a key ingredient of numerous company plans. In an industry facing stagnant growth, a manufacturer of textile dyes selected certain target segments potentially receptive to a value-added appeal—that is, segments sensitive to the advantages of dealing with a supplier whose products can minimize the number of "seconds" the customer may be forced to sell at reduced or distress prices. With a "partners in profit" mission, the manufacturer has successfully begun to promote use of high-quality dyes which, although they cost more, yield high-quality production runs and protect profit margins.

Most marketers claim already to be listening more closely to what their customers say. In several cases, applications engineers, as well as members of the regular sales team, are "hitting the road" to learn first-hand about customers' needs. The key to these and, indeed, all marketing efforts, several marketers remind, is the seller's ability to perceive the buyer's view. The marketing director of one industrial products company sums up its challenge this way: "Our customers are being presented with an incredible amount of environmental and legal challenges to their historic ways of doing business. We must analyze their situation and provide products and services that keep them on the leading edge of their respective markets."

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Research Bulletin

No. 208

The Conference Board

Summer Youth Employment: 1987 Edition

by Wesley Etheridge and
Nathan Weber

Management Summary

• Slight Increase in Placements

Public-Private Partnerships in 34 U.S. cities placed 151,600 youths in jobs during the Summer of 1986—an increase of only 1.2 percent over the previous summer.

Program administrators expect to place most of this summer's youths primarily in community improvement and maintenance jobs. Very few expect to place a majority of youths in fast-food establishments.

• Dropout Rate

The school dropout rate is pinpointed as a leading cause of persistently high youth unemployment.

Corporate Relations Program

About This Research

With the 1987 edition, the annual Conference Board survey of summer youth employment has been expanded from 14 to 34 major U.S. cities. This edition also uses data from each city's primary youth employment program, resulting in a more comprehensive picture of summer jobs in each locale. Most programs that report to the Board are administered by official Private Industry Councils; in a few instances they are directed by other public-private partnerships.

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Summer youth employment programs in 34 major cities throughout the United States placed 150,002 youths in jobs in 1986, an increase of 1,183, or 1.2 percent, over the Summer of 1985. (See Tables 1 and 2.) The programs are administered by Private Industry Councils or other public-private partnerships.

The 17 cities reporting increases over the previous summer indicated that the gains were accomplished through additional private-sector involvement, the availability of more jobs, earlier recruitment efforts, and increased funding from various sources in their areas. On the other hand, cities reporting decreases in the number of placements blamed federal grant reductions, the transfer of job-placement funds to assessment and remedial education programs, and the lack of young candidates possessing job skills sought by employers.

Most administrators of the employment programs predict an equal or better performance for the Summer of 1987: Of the 34 cities that responded to the annual Conference Board survey, 24 expect to place more or about the same number of youths as they did in 1986.

Seven respondents expect to place more youths in 1987. Their predictions are based on the extension of the Targeted Jobs Tax Credit (TJTC) (which gives employers a tax credit for a percentage of wages paid to teenagers hired during summer months), increased placement goals, and planned improvements in such areas as recruitment and private sector participation. Those who expect to place the same number of youths—17 cities—cite similar funding levels and job offers by companies.

Among the 10 respondents who predict a decline in the number of placements in 1987, the majority cited federal fund reductions and remedial education training costs that will not be covered by the government. Both factors are expected to reduce the money normally available for salary and administration costs.

Private Sector Contributions

Private industry donated $2,941,509 in cash, and at least $3,571,116 in in-kind contributions to the 34 cities during the Summer of 1986.

According to the youth employment program administrators, in-kind contributions included "loaned" executives, donated television, radio, newspaper and magazine advertisements, and printing services.

Youth Unemployment

The unemployment rate for young people during the Summer of 1986 was higher than the rate for the preceding year; for the population as a whole, however, unemployment decreased. (See Table 3.) In August of 1986, 14.3 percent of all teenagers and 35.3 percent of all black teenagers went jobless, while the national unemployment level last summer stood at 6.7 percent.[1]

Despite a decrease in the U.S. youth population and in the youth labor force, and despite evidence that this trend will continue, youth unemployment is expected to increase through the end of the century, according to the National Alliance of Business (NAB). NAB based its projection on "continued ineffective vocational counseling and job placement and lack of basic literacy skills of youth, particularly minorities."[2]

The study pinpointed an increasing school dropout rate as the leading cause of the youth unemployment trend. In turn, the NAB offered two factors that account for the rising number of dropouts—which is estimated by the NAB at one million youths each year. (However, the actual number as well as the methods of measuring it are disputed by experts.) The first factor is a soaring increase in teenage pregnancies which, NAB estimates, will prevent half-a-million young mothers from ever

[1]Source: Interview with U.S. Bureau of Labor Statistics official.

[2]National Alliance of Business, *Employment Policies: Looking to the Year 2000*, 1986, p. 2.

Table 1: Summer Job Placements: 1985 and 1986

	1986	*1985*
Albuquerque	1,070	1,208
Baltimore	4,012	4,004
Boston	2,347	2,320
Bridgeport	1,599	1,608
Buffalo	1,225	1,400
Charlotte	1,134	905
Chicago	25,835	23,000
Cleveland	7,103	8,400
Columbus, GA	1,213	1,346
Columbia, SC	155	154
Dallas	2,412	1,950
Denver	1,229	1,230
Detroit	9,850	9,500
Indianapolis	2,973	3,122
Jackson	590	629
Jacksonville	1,146	1,047
Jersey City	1,901	1,810
Little Rock	399	780
Los Angeles County	9,500	10,897
Louisville	2,355	2,000
Milwaukee	2,996	2,583
Minneapolis	1,358	1,714
New York	36,239	31,584
Oakland	2,124	2,020
Oklahoma City	550	691
Omaha	134[1]	358
Philadelphia	18,083	19,739
Pittsburgh	2,389	2,309
Portland	2,210	1,915
Richmond	910	820
Salt Lake City	1,188	1,059
San Francisco	1,044	1,389
Seattle	2,865	3,503
Tucson	864	1,145

[1]The comparatively low number of youths placed in Omaha in 1986 reflects the results of new procedures that required businesses to pay 35 percent of the young peoples' wages. In the past, contributions from larger corporations funded both the program's operating costs and youth wages.

Table 2: 1986 Placements in Private and Public-Service Sectors

	Private Sector	*Public Service*
Albuquerque	65	1,020
Baltimore	2,883	1,129
Boston	2,276	71
Bridgeport	78	1,521
Buffalo	0	1,225
Charlotte	307	827
Chicago	1,750	24,085
Cleveland	0	7,103
Columbus, GA	0	1,213
Columbia, SC	141	14
Dallas	270	2,142
Denver	0	1,229
Detroit	0	9,850
Indianpolis	897	2,076
Jackson	0	590
Jacksonville	1,146	0
Jersey City	0	1,901
Little Rock	46	353
Los Angeles County	0	1,901
Louisville	55	2,300
Milwaukee	1,195	1,801
Minneapolis	0	1,358
New York	36,239	0
Oakland	60	2,085
Oklahoma City	17	533
Omaha	134	0
Philadelphia	4,652	13,431
Pittsburgh	13	2,376
Portland	160	2,050
Richmond	660	250
Salt Lake City	110	1,078
San Francisco	961	83
Seattle	400	2,465
Tucson	13	851

Table 3: Seasonally Adjusted Summer Unemployment Rates: August 1985 and 1986

	August 1985	*August 1986*
Civilians	6.9	6.7
Teenagers (16-19 years old)	15.1	15.3
Black teenagers (16-19 years old)	32.4	35.3

Source: U.S. Bureau of Labor Statistics

completing school. The second factor is a lack of attention given to potential dropouts by school authorities.

The dropout increase is particularly distressful because many experts acknowledge that more and more jobs will require not only basic reading, writing, and math skills, but problem-solving, analytic, and communication skills as well.

Job Training Partnership Act

Another factor in youth unemployment may be problems inherent in the Job Training Partnership Act (JTPA), the major federal program addressing the issue. The Act, which provides states with funds for year-round training and for summer youth jobs, is reported to suffer from several programmatic deficiencies, according to some vocational experts.

Stressing low-cost, short-term employment and training services, and combining the efforts of the public and private sectors to serve economically disadvantaged youth, JTPA replaced the Comprehensive Employment Training Act (CETA). Unlike its predecessor, it does not place enrollees in jobs created for them, which some observers have called "make-work" positions. JTPA's programs are designed to train people for jobs in the private sector in an unsubsidized capacity.

Critics, however, claim that JTPA is "placement oriented." This, they argue, leads JTPA program directors to seek those people who are easy to train and place, most of whom were likely to obtain jobs on their own in any case. As a consequence, they say, those youths most in need of training and placement are largely ignored.[3]

Where the Jobs Were; Where they Will Be

Twenty-nine percent of the youths placed by public-private partnerships in The Conference Board's 1986 summer survey found jobs in maintenance; 24 percent were placed in clerical positions; 6 percent in fast-food establishments; and the remaining youths in delivery and other positions. (See Table 4.)

Most respondents to the survey (38 percent) predict that the majority of 1987 summer placements will be in maintenance; 29 percent predict that most recruits will find jobs in community service; and 26 percent see the clerical field as offering the greatest number of jobs. Reversing a summer employment trend, fewer youths are expected to be drawn to fast food establishments in 1987: Only 6 percent of those who responded to the Conference Board survey indicated that they expect to place most of next summer's recruits in fast food employment. (See Table 5.)

Lack of Jobs—Or Lack of Youth?

Evidence of a declining youth population in the United States has led several observers to maintain that jobs for teenagers are going begging. "Suddenly America is running up against serious labor shortages that are crimping many businesses and forcing corporate headhunters to work overtime," according to *Time* magazine.[4] In a similar analysis, *The Wall Street Journal* reported that the labor shortage will improve employment prospects for young people—since employers will have to hire

[3]Karen Blumenthal, "Off Target?: Job-Training Effort, Critics Say, Fails Many Who Need Help Most," *The Wall Street Journal*, February 9, 1987.

[4]George Russell, "A Maddening Labor Mismatch," *Time*, April 28, 1986, pp. 48, 49.

Table 4: Where Youths Were Placed in 1986 (Percent of placements)

	Clerical	Fast Food	Delivery	Sales Clerk	Maintenance/ Cleanup	Community Service	Other[1]
Albuquerque	58%	3%	0%	.02%	0%	0%	39%
Baltimore	30	20	2	14	14	0	20
Boston	61	9	0	17	19	15	11
Bridgeport	12	0	0	0	16	72	0
Buffalo	16	4	0	0	67	8	4
Charlotte	.01	13	.01	3	41	0	28
Chicago	28	22	3	13	7	2	25
Cleveland	16	4	0	0	54	2	25
Columbus, GA	20	0	0	0	40	20	20
Columbia, SC	12	25	.01	12	3	4	43
Dallas	28	0	0	0	17	55	0
Denver	33	0	0	0	38	0	29
Detroit	12	0	0	0	75	12	2
Indianapolis	25	8	.01	2	39	2	25
Jackson	34	5	0	0	59	3	0
Jacksonville	27	22	0	5	9	0	37
Jersey City	17	0	0	0	29	28	27
Little Rock	18	0	0	0	49	33	0
Los Angeles County	21	0	0	0	21	58	0
Louisville	13	0	0	0	47	6	35
Milwaukee	12	18	4	7	34	7	16
Minneapolis	26	0	0	0	13	27	34
New York	25	7	7	20	20	3	18
Oakland	37	0	2	0	9	47	5
Oklahoma City	37	2	0	0	29	26	4
Omaha	8	28	11	16	18	0	18
Philadelphia	32	6	0	16	14	18	10
Pittsburgh	3	0	0	0	41	42	14
Portland	9	0	0	2	20	36	36
Richmond	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Salt Lake City	N/A	N/A	N/A	N/A	N/A	N/A	N/A
San Francisco	44	.02	2	4	19	2	20
Seattle	20	10	0	15	20	25	10
Tucson	38	0	0	2	23	0	37

[1]Recreational aides, repairs, tutorial, social services, etc.

even unqualified people and train them—as well as look to other potential sources of labor, such as the elderly and the mentally and physically handicapped.[5]

To explore this issue in the cities surveyed, The Conference Board asked program directors whether the problem in their communities was an insufficient number of youths applying for existing jobs, or a lack of available job opportunities. Twenty of the directors responded that not enough jobs were available. However, their comments indicate that the problem goes beyond an actual scarcity of work. Other factors cited include a lack of jobs providing quality work experience, unattractive salaries in jobs that do exist, and insufficient skills among the youths. The remaining fourteen directors said not enough youths were available to take advantage of existing job opportunities.

The labor shortage has not hit all areas equally. According to an analysis in *U.S. News and World Report,* severe labor shortages are common in the suburbs of Boston, New York, Atlanta, parts of the Midwest, and California. But in Houston, Dallas, and other cities affected by the collapse in oil prices, jobs are filled quickly.[6]

Legislative Issues

New legislation and administrative developments affecting summer youth employment pertain to the minimum wage and to the targeted jobs tax credit.

[5]Martha Brennigan, "A Shortage of Youths Brings Wide Changes to the Labor Market." *The Wall Street Journal,* September 9, 1986.

[6]Kenneth R. Sheets, "Teen Jobs Go Begging This Summer," *U.S. News and World Report,* July 7, 1986, p. 59.

Table 5: Where Most of 1987's Summer Jobs Will Be

City	Job Category
Albuquerque	Clerical
Baltimore	Clerical
Boston	Clerical
Bridgeport	Community service
Buffalo	Maintenance
Charlotte	Maintenance
Chicago	Community service
Cleveland	Maintenance
Columbus, GA	Maintenance
Columbia, SC	Fast food
Dallas	Community service
Denver	Maintenance
Detroit	Maintenance
Indianapolis	Maintenance
Jackson	Maintenance
Jacksonville	Clerical
Jersey City	Maintenance
Little Rock	Maintenance
Los Angeles County	Community service
Louisville	Maintenance
Milwaukee	Maintenance
Minneapolis	Community service
New York	Clerical
Oakland	Community service
Oklahoma City	Clerical
Omaha	Fast food
Philadelphia	Clerical
Pittsburgh	Community service
Portland	Community service
Richmond	N/A
Salt Lake City	Community service
San Francisco	Clerical
Seattle	Community service
Tucson	Clerical

Minimum Wage Controversy

The effect on youth employment of the minimum wage, currently at $3.35 an hour, remains in dispute. The Reagan Administration maintains that an increase in the minimum wage, like all wage increases, would lead to inflation. It also maintains that an increase in the minimum wage would force employers to forego hiring, thereby exacerbating the unemployment problem. Administration officials have announced that they will block any efforts to raise the minimum wage.[7]

Labor advocacy groups, in contrast, argue that the "real" minimum wage—adjusted for inflation—is at its lowest level since 1955. The National Council of Employment Policy, a nonprofit group, maintains that increases in the cost of living have caused a decline in the wage's purchasing power by 26 percent since 1981, the year it was raised to $3.35. Concluding, therefore, that the current wage is not a cause of the prevailing high unemployment rates among youths, the Council is seeking an increase.[8]

Legislation to raise the wage to $4.65 an hour over the next three years was introduced in Congress on March 25 by Senator Edward M. Kennedy (Democrat, Massachusetts) and by Representative August F. Hawkins (Democrat, California.). The increases would reportedly affect the wages of about 10 million workers.

Extension of Targeted Jobs Tax Credit

The Targeted Jobs Tax Credit (TJTC)—which enables employers to receive a tax credit for a percentage of wages paid to youths hired during summer months and to other individuals hired during the year—was renewed on October 22, 1986 and will extend to hirings throughout 1988. However, a reported lack of employer interest in utilizing the credit led a number of states to halt certification soon after the old law expired in December 1985.[9] Citing the credit as ineffective, the Reagan Administration has opposed it. On the other hand, Senator John Heinze (Republican, Pennsylvania) has introduced legislation to make it permanent. According to Senator Heinze, the credit is underused "because employers can't count on its existence from year to year."[10]

Successful Youth Employment Programs

Vocational experts often claim that the most effective youth employment programs are those that combine remedial education with vocational training and employment, especially those that concern poor and undereducated teenagers.

Examples of programs that utilize such elements were reported by the Youth Policy Institute.[11] They include the following:

Summer Training and Education Program (STEP)

The Summer Training and Education Program (STEP) is a demonstration project run by Public/Private Ventures Corporation, based in Philadelphia. It enrolls economically disadvantaged teenagers as young as 14 years old and provides employment, job training and remedial education.

Since its inception, STEP has enrolled 1,600 14- and 15-year-olds at five sites. The youths receive minimum wage for working halftime. They also attend classes that emphasize not only

[7]Kenneth B. Noble, "Democratic Leaders Say Congress Will Increase the Minimum Wage," *The New York Times,* February 17, 1987, p. L-1.

[8]"Real Value of Minimum Wage At Lowest Level Since 1955, Council Says In Calling For Hike," *Daily Labor Report,* March 3, 1986, p. A-7.

[9]"Tax Report," *The Wall Street Journal,* October 29, 1986.

[10]"Sen. Heinze Plans to Introduce Bill to Create Permanent Jobs Tax Credit," *Daily Labor Report,* March 6, 1987, p. A-16.

[11]Darryl Brown, "Promising, Promising: Existing Programs Prove We Can Beat Youth Unemployment," *Youth Policy,* July 1986, pp. 18-19.

job skills, but also "life skills," such as responsible social behavior and decision-making. According to STEP administrators, youths in the program show marked improvements in academic and job skills.

Jobs For America's Graduates (JAG)

Jobs for America's Graduates, begun in 1980, works with high-school seniors who are in danger of failing or dropping out. It provides job training and placement to students who are, for the most part, not prepared to find "decent" jobs on their own after graduation.

JAG's emphasis is on job search and career planning techniques, work attitudes (reported to be poor among newly-hired young workers[12]), basic skills, and the obtaining of a diploma. JAG participants received up to five hours a week of direct contact with staff through seminars, lectures and other learning activities. The program reported a 90% placement rate. However, not all JAG students were identified as the most "at-risk" teens, and only half were from low-income families.

Job Start

Job Start, now operating in 11 cities, is targeted specifically to poor dropouts between ages 16 and 24 who read below the eighth-grade level, are in need of remedial education and employment skills, and who qualify for federal job training. Currently, 650 participants are enrolled in Job Start centers, where long-term training in academic and trade skills is provided.

[12]Leonard Lund and E. Patrick McGuire, *The Role of Business In Precollege Education.* The Conference Board, Research Bulletin No. 160, 1984, p.5-6.

Participants may hold part-time jobs. This program has been compared with the federally operated Job Corps—which has been credited with a 75 percent placement rate—in its ability to reach the hard-core unemployed.

Prescriptions For Improvement

Youth employment program administrators who responded to the Board's survey agree on many of the steps needed to improve summer youth employment prospects. According to the project director in Omaha, for instance, job opportunities for youths would increase "either if public transportation to areas outside of the city was provided, or if more inner-city jobs were created." And, according to the youth employment director in Columbus, South Carolina: "Additional economic development in nonurban areas and a more comprehensive public transportation system would definitely improve youth employment prospects."

The majority of the program directors, however, report that the most effective means of improving youth employment prospects is through more involvement from the private sector, particularly in an era of federal funds cutbacks. The program director in Cleveland commented: "We need to see a much greater commitment from the private sector, other than in fast-food jobs. If the federal government is going to continue to reduce funding, then it is essential that someone take up the slack. We need the expertise and knowledge of the private sector—and more money!" The program administrator in Portland added: "The private sector must see itself as a partner in training youth for employment. Unless this happens, and even if federal funds do not decrease further, we will still be severely limited in the number of youths we can serve."

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No. 209

The Conference Board

Forecasting Public Affairs Priorities: 1987 Edition

by Catherine Morrison

Management Summary

How Do Companies Rank Issues?

The ten most important issues are:

1. Tax reform
2. Environmental issues
3. Tort liability reform
4. Health care
5. Deregulation
6. Protectionism
7. Technology and economic competitiveness
8. Reregulation
9. Budget deficit
10. South Africa

Company Commentary on Key Issues

Officers comment frequently on the issue of technology and economic competitiveness, using it as an umbrella to cover fair trade vs. protectionism, regulatory reform, productivity and standard-of-living.

Tax reform continues to concern most corporate officers.

Environmental protection, particularly regarding toxic waste disposal, remains high on the list.

Forecasting Emerging Public Policy Issues

Companies see continuing concern with current issues rather than the emergence of new topics. The issues most likely to be of concern in the next three years are:

1. Tax reform
2. Environmental issues
3. Protectionism
4. Deregulation
5. Tort liability reform

Corporate Relations Program

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Introduction

Each year The Conference Board polls public affairs officers on how they assess and manage the variety of concerns that come under the rubric of public policy issues, on how concentrations of staff and resources shift over time, and on the anticipated courses of action. The Board's study is not only interested in corporations' concerns about changes in the social, political and economic environment, but also in how firms affect the legislative process and which efforts companies find most effective.

This is the second survey in a continuing series that will allow Conference Board researchers to monitor corporate perceptions on a broad range of issues. The Board effort focuses on those national and international issues that currently, or may in the future, affect the ways in which firms are permitted—or required—to do business.

Recognizing that many firms are profoundly concerned with state and local issues, this study deals with such topics when possible. In most cases, however, detailed accounts of local issues are beyond the scope of this report. Other Conference Board activities and reports address local issues more thoroughly; the majority of issues in this survey involve matters of national public opinion or policy.

Adapting To Change

When corporations are required to streamline their operations—due to mergers, down-sizing or restructuring—the process of identifying and tracking issues often becomes subject to close scrutiny, and its effectiveness is weighed with care.

Corporations make substantial investments in this intelligence-gathering process, and for many reasons. First, corporate managements abhor uncertainty because it renders long-range planning impossible. Most public policy issues seem to involve change and, in order to prepare for change, corporations must have some idea of the dimensions of possible organizational, financial and managerial shifts. An early warning on either changing public attitudes or the emergence of a concern new to the public or lawmakers is of critical importance for executives.

This Conference Board survey focuses not only on which issues concern companies but also on how effective firms are in shaping the legislative agenda (See Exhibit 1). In response to the Board's 1985 survey, public affairs officers said their companies were more often reactive than proactive. In 1986, more companies report that their lobbying efforts have started earlier in the process and, as a result, are more effective. "We have become more concerned with getting out front early on an issue," reports one respondent whose firm is involved in a variety of disparate issues.

How Companies Rate Their Early Warning Abilities

"We can deal with almost anything if we know it's coming, but we spend a good deal of time preparing for 'non-events'. The time spent is worth it to us because of the nature of our business—we can't afford to have a crisis catch us unaware.

"Primarily, our time is spent on issues of immediate concern; secondarily, on contingency plans for a crisis situation. Less time is spent on emerging issues."

—a diversified manufacturing company

Nonetheless, most companies consider themselves well-prepared to deal with public policy issues that are of immediate concern, as well as to identify early-on those issues likely to concern them in the near future. A fifth of those surveyed rate their early-warning systems as "excellent," a percentage similar to the 1985 response. In 1986, ten percent more see their systems as "good" than did in 1985, while only two percent of all respondents believe their companies handle issues identification poorly. (See Table 1.)

The Corporate Tracking Effort

A slight shift in the corporate issues-tracking effort has occurred between 1985 and 1986. In 1985, 53 percent reported that they did not have a "formal" issues-tracking effort. In

About This Report

In order to assess how corporate officers define, rank and manage various public policy issues facing their organizations. The Conference Board conducted a mail survey and field interviews during the Summer and Fall of 1986. A list of 1,200 public affairs officers was selected from the 1,000 largest industrial firms and the 200 largest services companies (including finance, transportation, and insurance). Questionnaires were mailed to these companies and 232 usable responses were obtained. Approximately three-quarters of the respondent companies were manufacturing firms and the remainder were service firms from the services sector. Data from these questionnaires constitute the principal source of information for this report. Personal and telephone interviews were conducted with public affairs officers, government affairs officials, and functional executives in other relevant departments of the respondent companies in order to gain additional insights on issues affecting these units' operations.

Because of ongoing legislative activities that alter the status of various issues (for example, tax reform and environmental regulations), and because of the volatility of other issues, this analysis represents a picture of corporate concern at a particular point in time. This is the second survey in this area, and The Conference Board intends to repeat this study at regular intervals, with the first report (1985) serving as a baseline against which shifting attitudes and priorities can be measured.

The survey was initially conducted in response to inquiries from CEOs, public affairs officers, and other senior executives seeking to obtain comparative data on how competitors and other companies of similar size and organization perceive and involve themselves in various public policy issues. Because this report measures both the rank order of the issues (in terms of their importance to the corporation), as well as the degree and type of corporate involvement in them, it should provide a useful response to such questions.

Exhibit 1: Issues Management: a Process for Impact

(A manufacturing company's summary of the firm's issues management process.)

Government Relations means:

— Corporate Communications with Government
— Issues Management
— Political Action Committee

Government Relations Goals and Objectives:

The overall goals of the government relations department are to develop an effective and proactive program that is fully integrated with business strategies and operations, and to utilize effectively staff, budget and outside resources to expand and improve our issues management and the political action committee (PAC).

Legislative Objectives:

Identify legislative objectives that require active support. Specific objectives are identified for each session of Congress and for the state legislative sessions. In arriving at these legislative objectives, the following criteria are used:

(1) How significant is the impact on the company?
(2) Can the company affect the development of the issue?
(3) Does the issue complement the overall business-and government-relations strategy?
(4) Are resources available for the issue?

Operational Objectives:

Discuss potential issue objectives with the relevant operations or corporate staff so as to insure that the issue fits the criteria for action.

Issue Categories:

Each identified issue is placed into one of three levels of priority so that company resources and time are used most effectively.

First Priority:

Issue of primary concern to the company; issue meets the four criteria for priority treatment.

Second Priority:

Issues are monitored, but less staff time is anticipated on them. Company involvement occurs only if the status of the issue changes significantly.

Issues Management:

Surveillance/forecasting/identifying/tracking
Evaluating/prioritizing
Assigning responsibility
Structure
Position and strategy development
Implementation
Measurement/feedback.

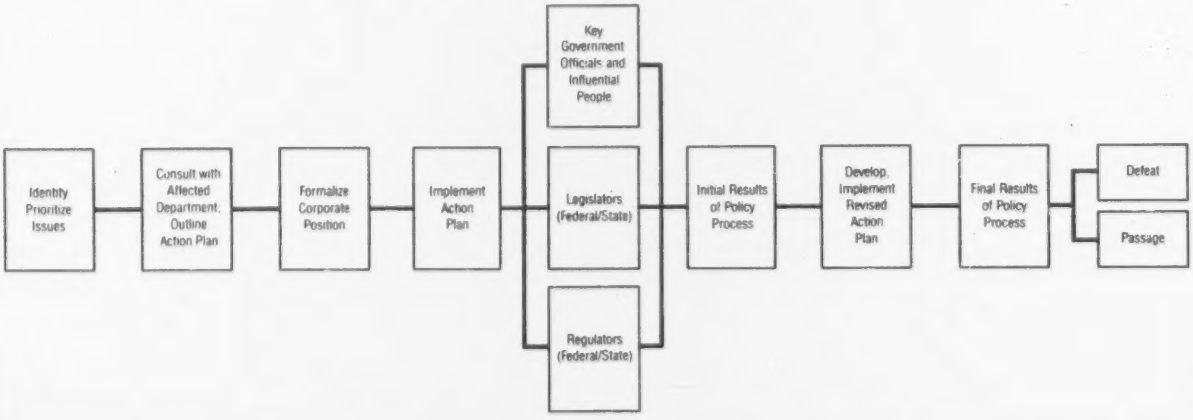

Table 1: Companies' Evaluation of Their Ability to Identify Key Public Policy Issues

Evaluation Rating	1986 Percent of Companies (N=223)	1985 Percent of Companies (N=252)
Excellent	20.0%	21.0%
Good	55.0	45.0
Average	23.0	31.0
Poor	2.0	3.0
Total	100.0%	100.0%

1986, this group of respondents reflects a minority voice of 49 percent, with a 51-percent majority designating specific individuals or groups as now having responsibility for the issues identification and management function.

As in 1985, nine out of ten companies rely on internal staff for identification and tracking activities. Only 5 percent contract their work to consultants, although almost all have subscribed to outside polls and services at some time. Seven percent rely both on internal staff and outside consultants, using the consultants to identify and track highly specialized and complex issues.

In 1985, most firms using outside suppliers did so in order to gain objectivity, reduce staff costs and obtain the advantages of the shared costs of multi-client surveys and studies. In 1986, most outside contractors were sought because of the technical nature of the issues (for example, tax reform, tort liability, and the more detailed aspects of the international trade question). The specialized information required to analyze such subjects was beyond the scope of most generalists.

One public affairs vice president, reflecting on his firm's tracking effort, noted:

"Our primary target for communication is the elected official, and we reach him by bringing as much of the company's resources to bear as we can muster.

"First, we identify issues and trends. Information is gathered from external sources, but officers and managers at all levels make the final identification.

"Second, we set priorities. Government affairs staff assists corporate officers in this, and a consensus is achieved. If the issue requires action, a project team is assembled and analysis is begun.

"A range of company positions and action plans are presented to the CEO. The final decision is his."

Briefing Top Management

Regardless of whether issues agendas are presented to top management formally or informally, through discussions, committee meetings, and the like, only one-third of the companies say their CEO participates in the issues-identification process. Unit-level managers, however, have a strong role in developing an issues agenda in over three-fourths of the cases presented.

In 1985, 63 percent of the respondents did not use a formal issues agenda. In 1986, only 57 percent chose this practice. These companies prefer to use an issue-by-issue approach, or depend upon information from trade associations and informal discussions and meetings. Often, discussions rest upon senior executives' abilities to prioritize matters of concern to their companies. Procedures of some companies include the following:

"Special reports are prepared regarding selected issues. In addition, an issues survey is administered annually and results are widely circulated at the management level."

—a manufacturing company

"At the holding company level, a corporate policy council and corporate information council meet regularly to review company-related issues. At the operating level, an Executive Management Council of the officers meets regularly for the same purpose."

—a telecommunications company

"System company peer groups identify emerging issues which are presented to the system vice president and through him to the president's committee and the chairman."

—a utility company

A recent Conference Board report discusses in detail the role of task forces and committees, and how the committee mechanism serves both senior corporate management and the company as a whole. Based on survey information from 284 companies, the author reported:

"Task forces and special committees are presented in more than two out of five of the surveyed companies, and two in ten say that such groups have grown in importance during the past two years. Task forces are usually created in order to bring diverse internal expertise to the consideration of new issues while committees tend to deal with issues of continuing or intermittent concern. The terms, however, are often interchangeable.

"General Mills' Vice President for Public Affairs describes a committee that was created recently in connection with the discovery that a pesticide used by grain handlers as a fumigant was potentially carcinogenic: 'This was an issue that crossed departmental lines. We recognized that actions contemplated by governmental relations, legal, corporate communications, quality control, or operations group would have consequences in other areas and needed to be unified in order to have a coherent corporate strategy. So we put together an interdisciplinary team of legal, business, political, scientific and communications people chaired by a member of top management—in this case the Vice Chairman—to develop a strategy that would guide each of their functions but not be inconsistent with the strategies of the others. As long as mechanisms like this exist, conflicts between units are

Table 2: Ranking of Issues By Importance—Geopolitical Boundaries

Geopolitical Issues Category	Percent of Firms									
	1st		2nd		3rd		4th		5th	
	1986/1985		1986/1985		1986/1985		1986/1985		1986/1985	
National Issues	54%	53%	17%	21%	15%	11%	15%	15%	—	—
States Issues	31	33	40	41	18	20	9	6	2%	—
Local Issues	7	9	17	14	30	30	27	28	19	20%
International Issues	4	6	15	15	14	15	16	14	51	51
Regional Issues	3	2	11	10	33	27	28	35	25	25

Column totals may not add to 100% due to rounding.

minimized and organizational confusion avoided. In addition, we found that the quality of particular functional strategies was improved.'

"Public affairs units normally provide staff support to task forces and special committees, but occasionally play a managing role as well. 'We typically gather and circulate information about an issue to members, ask for their input, and then hold sit-down sessions to establish its significance to the company and to develop a position,' the top public affairs executive at a manufacturing firm says."[1]

Downsizing the Issues Management Function

Often, economic forces shape the size and direction of the issues-tracking effort. The senior vice president of a major conglomerate states:

"A major reorganization and cutback has drastically altered our issues management activities. But it has not been all that damaging.

"The question for me was, how can I maintain the same level of input, the same commitment on the part of plant managers to participate in the public policy process, without this interactive process? We decided to bring the issues process to the plant managers instead of vice versa.

"So far, it seems to be working. I can't honestly say that the cutbacks have hurt us functionally. We're a leaner operation now but, at the same time, more focused. We still seem to be able to do our job well, even though morale is low. Only time will tell."

While some companies did not respond to the survey—due to mergers and uncertainty as to the future of their unit, dissolution of the issues function, or downsizing of their companies—one-quarter of the firms did report having experienced a reduction in their issue-analysis function. Eleven percent of the companies responding had cutbacks of 25 percent or less, while 4 percent report cutbacks of between 25 and 50 percent. One firm's issues department was disbanded and a small portion of the respondents (2 percent) report cutbacks in excess of 60 percent.

Outside research assistance was sought on a variety of issues, many of them local. On a broader scale, the ramifications of the then-proposed tax reform (now a reality) caused 10 percent of the respondents to seek outside analysis. Trade issues accounted for 5 percent of the activity in outside services.

As mentioned earlier, the complexity of both the proposed tax changes and the implications of various trade bills placed these issues beyond the scope of issues management staffs; the drift toward outside assistance is not so much reflective of the corporate cutbacks as it is of the need for highly specialized skills. Other areas in which assistance was sought were health-care cost containment, South Africa disinvestment decisions, tort liability reform, and the federal budget deficit.

While 20 percent of the respondents sought outside assistance in 1985-1986, only 18 percent planned to do so in 1986-1987.

Geopolitical Concerns

As Table 2 illustrates, in 1986 national and state issues continued to receive the most attention from the firms surveyed—much as they did in 1985. But over half the companies studied allocate substantially more resources to national issues. However, nearly a third rank state issues first.

In 1985, it was the multinational companies that tended to give international issues priority. Those companies whose products are intended primarily for domestic markets were less apt to cite international issues as being of critical concern to their firms. By 1986, however, global economic and international trade questions had become increasingly important to domestic companies as well, and they began to press more aggressively for import controls.

As might be expected, businesses subject to state regulation—insurers, banks, telecommunications firms—continue to monitor carefully and devote substantial resources to state issues.

[1]Seymour Lusterman, *The Organization and Staffing of Corporate Public Affairs*. The Conference Board, Report No. 895, 1987.

Levels of Corporate Involvement

For the purposes of this study, three levels of corporate involvement were identified, "active involvement," "close monitoring," and "general interest." (See Table 3.) Each level reflects a different allocation of company staff and resources, thus indicating the level of concern with a particular issue.

On issues of primary concern to the company, where the level of interest is reflected by an active lobbying effort, the support of advocacy groups that espouse the corporation's position, or the assignment of company staff and resources to a particular issue, companies are described as being "actively involved." These issues tend to be those thought likely to involve legislation that would—or could—impede a company's manufacturing or marketing operations. In a few cases, such as tax reform or trade policy, an issue may so significantly affect the overall economic climate of the country that a company will inevitably expect an impact.

Secondarily, companies may keep a wary and watchful eye on the development of an issue without any actual "involvement." In these cases, they have not yet committed themselves to a lobbying effort, or attempted to affect public debate by advertisements, public pronouncements, or support of advocacy groups. However, they are watching the issue closely through the use of company staff and outside resources, and are tracking and reporting on such developments. These companies are said to be in a stage of "close monitoring."

Third, companies may have merely an "intellectual interest" in the issue because of its general impact on the nation's economic and social system. These firms will expend no special effort to collect information on such an issue, but will keep themselves informed about its development.

The latter category of activity should prove useful to companies as they observe how long it takes an issue of "general interest" to achieve major significance or, conversely, how long an issue hovers in a "general interest" category before disappearing. Finally, as might be expected, there are some issues that firms say they pay no attention to at all.

How Companies Rank Issues

A list of issues that companies could choose from was provided in the survey. The issue topics selected for the survey come from several sources: the 1985 survey results; a polling of public affairs executives; and a regular review of secondary sources such as industry surveys, public opinion polls, tracking of media coverage, monitoring of legislative initiatives, and so on. In total, 24 separate issues were identified. (See box insert, page 10.)

Changes in the Issues Menu

Inevitably, there was substantial change in the menu of issues between 1985 and 1986. Some issues considered to be important in late 1984 and early 1985 were dropped from the 1986 survey. These were:

1. Federal reserve issues
2. Third World issues
3. Religion and business
4. Immigration reform
5. Aid to Israel
6. Ethnic discrimination
7. Age discrimination
8. Disarmament negotiations
9. Local community issues

Other issues, such as international investments, do not appear in the 1986 survey because the subject was too broad to elicit usable responses or conclusions.

Issues new to the 1986 survey appeared as a result of respondents' additions to the 1985 issues list. These are:

1. Public health
2. Tort liability reform
3. Privacy
4. Middle East
5. Farm prices and policies
6. Right-to-know
7. Specific environmental issues

A number of issues from 1985 reappear in 1986 but are worded differently. The topic entitled federal budget deficit and related tax reform has been separated into two separate issues, reflecting corporate commentary on the original phrasing. Regulatory reform has been replaced by deregulation; international trade has been divided into two parts: protectionism and the issue of technology and economic competitiveness. The topic of economic concentrations has been replaced by antitrust issues, and structural unemployment by job creation and/or retraining.

The Single Most Important Issue

When asked to describe the single issue of most pressing concern to their company, 30 percent of the respondents chose not to raise one key issue to that level of importance. Of those who did respond, more than one-quarter listed tax reform as the single most important issue affecting their company's profits. Deregulation was cited less frequently, by almost 14 percent of the panel, and protectionism ranked third, garnering an 11-percent response. Environmental issues, tort liability reform and technology and economic competitiveness followed closely behind.

If, however, the trade-related issues are grouped together—

- Deregulation
- Protectionism
- Technology and economic competitiveness
- Reregulation

—the picture changes considerably. Many respondents did, indeed, cite issues in this group as being of the most critical concern to their companies.

Table 3: Levels of Corporate Involvement in Public Policy Issues

Title of Issue	Percent of Firms Actively Involved or Closely Monitoring	Percent of Firms Actively Involved		Percent of Firms Closely Monitoring		Percent of Firms Reporting General Interest	
	1986	1986	1985	1986	1985	1986	1985
1. Tax Reform	94.1	70.1	*	24.0	*	5.9	*
2. Tort Liability Reform	78.2	47.3	*	30.9	*	20.5	*
3. Health-Care Cost Containment	74.4	39.9	41.2	34.5	37.0	22.0	18.1
4. Environmental Issues	67.1						
a. acid rain		24.7	—	24.7	—	24.2	—
b. clean air		32.4	—	26.5	—	22.8	—
c. toxic wastes		33.0	—	31.2	—	21.3	—
d. other		29.7	—	24.8	—	26.9	—
5. Deregulation	67.0	41.9	41.6	25.1	25.5	28.4	30.0
6. Technology and Economic Competitiveness	65.0						
a. research support		19.1	—	22.3	—	44.7	—
b. tax credits		32.1	—	30.7	—	28.4	—
c. copyrights and patents		17.9	—	22.2	—	41.5	—
d. science and engineering education		14.1	—	20.2	—	46.0	—
7. Financial Disclosure	63.5	15.3	19.8	48.2	42.8	30.2	30.5
8. Reregulation	59.9	25.3	31.5	32.6	31.1	34.8	29.5
9. Right-to-know	59.5	23.0	—	36.5	—	31.5	—
10. Protectionism	57.0	26.5	*	30.5	*	25.1	*
11. Employment Discrimination	57.0						
a. comparable worth/pay equity		12.2	15.2	44.6	50.6	41.0	30.0
b. handicapped		5.2	12.4	35.2	36.8	51.2	46.3
12. Campaign Financing Reform	59.9	13.0	20.2	43.9	43.2	35.4	29.2
13. Budget Deficit	54.2	16.1	*	38.1	*	43.9	*
14. Plant-Closing Statutes	51.1	19.3	19.8	31.8	33.7	37.7	29.2
15. Employment-at-will	48.4	5.9	7.8	42.5	41.2	47.5	41.2
16. Antitrust	36.8	9.9	14.8	26.9	43.2	48.9	37.0
17. Family Issues	34.5	5.8	7.9	28.7	25.7	53.4	54.8
18. South Africa	33.8	16.2	12.5	17.6	13.8	30.2	19.2
19. Privacy	33.3	4.9	—	28.4	—	59.0	—
20. Public Health	32.3	12.6	—	20.3	—	50.9	—
21. Job Creation and/or Retraining	30.7	5.0	7.9	25.7	16.7	51.4	55.8
22. Education and Business	20.8	10.4	21.0	10.4	19.8	49.5	45.7
23. Middle East	19.3	4.5	—	14.8	—	35.9	—
24. Farm Prices	15.5	5.5	—	10.0	—	30.0	—

* Appeared in the 1985 Survey but in a different form
— Not included in the 1985 Survey

The Ten Most Important Issues

Issues are weighed in two ways in this report. First, companies report on their degree of involvement and concern (Table 3, page 8). Second, companies are asked to rank the top ten most important issues affecting their firms, selecting from among the 24 issues available, or going beyond the given list. The following areas, listed by frequency of mention, received the most comment:

1. Tax reform
2. Environmental issues
3. Tort liability reform
4. Health care
5. Deregulation
6. Protectionism
7. Technology and economic competitiveness
8. Reregulation
9. Budget deficit
10. South Africa
11. Public health issues
12. Plant-closing statutes

By contrast, the 1985 rankings were as follows:

1. The federal budget and related tax reform
2. Regulatory reform
3. Environmental protection
4. Energy development
5. International trade relations
6. Health-care cost containment
7. Economic concentration
8. Local issues
9. South African investment
10. Plant-closing laws

Tax reform has clearly been a major concern of an overwhelming majority of companies for the last two years and will probably continue to be while there is still uncertainty as to the fallout from the new tax law. Over 50 percent of the companies are actively involved with a variety of environmental issues, citing "the disposal of toxic wastes as the single most critical issue of our time." More than one-third of the companies say tort liability reform is "long overdue" and increased litigation will "cripple their industry unless brought under control." Health-care cost containment continues to preoccupy management in one-third of the companies responding, while energy, telecommunications and transit regulations are no longer seen as high-priority issues. The years 1987 and 1988 will probably see renewed concern over banking and financial services regulation as Wall Street insider-trading scandals develop further.

The appearance of the issue of technology and economic competitiveness among the top ten serves as an umbrella for the various free trade, protectionism, regulatory reform, productivity, and standard-of-living questions that will be the subject of much debate in Congress.

Company Commentary on Key Issues

Company spokespersons are asked to comment on issues of particular concern to their companies and to elaborate on the reasons for that concern. The following areas received not only the most frequent, but also the most thoughtful, comment.

Tax Reform

The ramifications of changes in tax policy preoccupied almost all respondents to the survey. They recognized that the public was dissatisfied with what it perceived to be the unfairness of the tax system and was calling for change. Although tax reform proposals had surfaced frequently, they had never been successfully maneuvered through the Congressional shoals. Many expected the proposal to fail again.

Business was not united in its approach to tax reform. Some business groups—and some individual companies—chose to associate themselves with the reform movement, believing it to be strongly market-oriented because of its promise to radically lower tax rates and foster productive investments rather than encourage tax shelters.

Needless to say, companies that find themselves in the top 500 U.S. taxpayers' category look with favor on the tax reform act. Others, however, believe that revenue proposals for continued deficit reduction will threaten corporate earnings. Energy companies are particularly sensitive in this regard:

"The trend will be, at all levels of government, to shift public sector costs away from individuals toward business. Federal tax reform will impact on state taxation, as will declining oil prices. The energy industry will continue to remain a prime target for tax increases."

—an oil company spokesperson

State and local tax questions were a high-priority item on many companies' lists, particularly in states facing huge financial problems, such as Texas. An agricultural products manufacturer writes, "as a result of federal tax reform, we foresee pressure on the states to return windfalls to the taxpayer."

Some respondents were skeptical as to the probable success of the new tax reform plan, which at the time of the survey had not yet become law. Comments include:

"Past experience indicates Congress will revisit this issue annually."

—a diversified consumer goods manufacturer

"Tinkering will continue, even with passage of this bill."

—a rubber products manufacturer

"It won't end here. There will be continual pressure to change our method of raising taxes. It will shift from income to consumption. We are monitoring this issue very carefully."

—a food products manufacturer

"The elimination of the investment tax credit and changes

Issues Descriptions

*** Aid to Israel:** Implication of extended aid to firms with buy-back responsibilities and those doing business in the Middle East.

—Antitrust Issues: Junk-bond financing of mergers.

—Budget Deficit: The continuing struggle to achieve a balanced budget: Gramm-Rudmann-Hollings, etc.

—Campaign Financing Reform: PACs

—Deregulation: Further relaxation of regulations affecting business.

*** Disarmament Negotiations:** The efforts and strategies to gain mutual arms reduction.

Education and Business: New federal aid to institutions; participation in the performance and structural aspects of the educational system.

Employment Discrimination:

* a. Age: Issues involved in promotion, forced retirement, new employment.
b. Comparable worth/pay equity: The claim that the relative wage levels of jobs should be equitable and not affected by gender discrimination.
* c. Ethnic discrimination: Discrimination by race, creed or nationality.
d. Handicapped: Training and provision of facilities to encourage employment of the handicapped.

Employment-at-Will: The doctrine addressing wrongful discharges and the issue of employment security.

—Environmental Issues:

a. acid rain
b. clean air
c. toxic waste
d. others

Family Issues: Day-care assistance, part-time work with prorated benefits, maternity leave as a disability.

**** Farm Prices/Policies:** Low income and high debt leading to increasing foreclosures.

*** Federal Reserve Issues:** The effect of monetary policy on interest rates; oversight; lobbying to limit the powers of the Federal Reserve Bank.

Financial Disclosure: Additional requirements regarding the release of company finances and operating results to the public, stock analysts, the media, etc.

Health-Care Cost Containment: Regulations to help contain costs by limiting doctors' fees, hospital growth; related delivery-system efficiencies.

*** Immigration Reform:** Proposed employee identification; employer liability for the hiring of aliens.

*** International Investments:** Issues of joint ownership; technology transfer; expropriation; repatriation of assets; protection of facilities and employees against terrorist attacks.

Job Creation and/or Retraining: The effects of long-term changes in labor pool requirements.

*** Local Community Issues:** Housing, zoning, industrial development, crime, etc.

**** Middle East:** The resolution of political issues.

Plant Closing Statutes: Regulations regarding the closure of plants, strictures on location of new facilities.

**** Privacy:** An employer's need-to-know in conflict with an employee's civil right to privacy.

—Protectionism: Competition from foreign imports, subsidies, loan guarantees.

**** Public Health Issues:** AIDS, Medicare.

*** Religion and Business:** The impact on business of organized religious groups' advocacy of their interests.

**** Right-to-Know Issues:** Workers' and communities' rights regarding disclosure by firms of potentially hazardous products or processes.

Reregulation: Reimposition of regulation in selected business sectors.

South Africa: Apartheid, disinvestment.

*** Structural Unemployment:** Retraining workers and redirecting students' career choices to reflect long-term changes in labor pool requirements.

—Tax Reform: The impact of proposed changes in U.S. tax policy.

**** Technology and Economic Competitiveness:** Research support, tax credits, copyrights and patents, science and engineering education.

*** Third World Issues:** The extent of concern regarding safety and public health issues in Third World countries.

**** Tort Liability Reform:** The effects of court costs, liability insurance, and the development of alternative systems.

Key:
**** Issue dropped out of 1986 Survey***
***** New Issue for 1986 Survey***
—Issue appeared in 1985 Survey but in a different form
(No symbol) Issue unchanged from 1985 Survey.

in depreciation will have a serious impact on our industry's future growth."

—an aviation industry officer

"Implementing the Gramm-Rudman balanced-budget bill will cause chaos."

—a brewery

Environmental

With renewal of the "Superfund" toxic-waste program and uncertainty about the Clean Water Act resolved, corporate concern over implementation of these programs will continue. Not only are environmental programs costly, but business wonders if these programs are capable of meeting their aims.

Survey respondents expect acid rain legislation to be a top Congressional priority, with Members divided along regional lines. Midwestern and coal-producing states are pitted against the Northeast, which eventually receives much of the sulfur dioxide and other pollutants transported through the air and falling as acid rain.

Of all the environmental issues mentioned, none was a more pressing management concern than toxic waste disposal; companies see no easy or immediate solution. A metals manufacturer comments: "Public hysteria over toxic waste treatment and disposal is paralyzing the industry; yet the wastes continue to be generated." Other comments include:

"Hazardous waste disposal will produce more regulation at the state and national level."

—a forest products company

"Toxic substance exposure control and clean-up will remain issues for many years."

—a chemical company

"Control technology will not be able to keep up with detection capability, as regulators will be searching more intently for ways to control the discharge and disposal of toxic substances. Risk assessment will need to be expanded."

—a paper producer

"The erroneous perception of an industry with deep pockets will place additional unrecoverable burdens on the oil business."

—a petroleum products firm

Chemical companies displayed an intense interest in hazardous chemicals, saying the "control and reporting of defined hazardous chemicals used in the manufacturing process can have a significant effect on the cost of our products." And another respondent says: "Waste minimization and ground-water quality are issues which can, when handled properly, positively affect our company. If handled poorly, there could be a strong, negative impact."

A waste management company states: "We will continue to evaluate landfills, incineration and recycling to see that our wastes are handled economically and with community approval. Without community and governmental approval, we will surely have to close our chemical operations."

Utility companies continue to identify acid rain as a major concern both to their companies and to the industry as a whole. A western utility company executive writes: "Generating-plant scrubbers are an extremely expensive and still questionable remedy. They need to be given the opportunity to demonstrate environmental efficiency. Chief among the technologies available is front-end cleaning."

But some businesses' problems are opportunities for others. A Western gas company officer comments: "Stringent acid rain and air pollution guidelines will impact the cost of electricity and make gas more competitive."

Tort Liability Reform

Concern about tort liability and commercial insurance reached its highest level of attention to date in 1986. As another Conference Board study has shown, the media was replete with "warnings of impending breakdowns in the insurance industry and predictions of dire consequences for business and the economy in general unless serious reforms were enacted."[2] Tort reforms were passed in about 40 state legislatures.

Public affairs officers of the companies responding to this study said they feared the pressures brought on other units of their firms by the proliferation of product liability lawsuits, while at the same time noting that there is pressure brought to bear on them to develop better and safer products, labels and use-instructions. They feared that insurance would become either unavailable or so high as to preclude the production of competitively priced products.

Those industries most frequently citing concern with these issues are food-products manufacturers, chemical and pharmaceutical companies, and airlines.

Companies see their active involvement in this issue continuing. Some will continue to lobby at the state level; others will have more broadly-based activities:

"Our firm will continue to take an active role in shaping tort reform at the local, state and national level."

—an insurance firm

Some companies, however, are critical of state response to this issue:

"State governments are reacting to the crisis without understanding the etiology. Much more needs to be done in collecting and analyzing data to allow for lawmakers to make informed decisions about insurance company regulation and tort reform."

—an agricultural products manufacturer

[2]Nathan Weber, *Product Liability: The Corporate Response.* The Conference Board, Report No. 893, 1987.

Increased costs—or the expectation of increased costs—are an important factor in company deliberations:

"Prices have skyrocketed, especially for directors. Insurance premiums generally are increasing the cost of doing business."

—a retailer

Several companies expressed concern with product liability, calling for "a major reform in this area," the need for which is "obvious and widespread." An insurer writes, "tort reform must be implemented to cut costs to society." The aviation industry sees the need for "available and affordable insurance protection against catastrophic accident."

Firms are concerned with both the short and long-term impacts of this issue:

"The escalating product liability judgments and their actual and potential impact on our near-term business and future product line is a continual concern."

—a chemicals manufacturer

"The long-term impact on the regulation of the entire insurance industry makes this more than a property/casualty issue."

—an insurance firm

"The move to reform must continue even if insurers' results improve. Insurance is not the only element of the U.S. society that is harmed by the present system."

—an insurance firm

Deregulation

Companies are calling for increased deregulation, particularly in the financial services sector. Financial institutions are now performing a multiplicity of services, and the number of regulators on both the state and federal levels is often called into question.

At the same time, the problems that the trucking and airline industries have experienced following deregulation are keeping companies watchful. The rise in the number of trucking accidents, the rate of failure of licensed motor carriers, the concentration of airlines, and the ensuing decline in services and reliability are causing companies to realize that further deregulation will need to be accompanied by careful legislative consideration of problems and solutions.

In responding to this survey, utilities, telecommunications firms and banks were predictably among those industries pressing for further deregulation. A gas company executive comments: "Deregulation of gas prices makes the marketplace much more volatile than in the past. This, combined with tax rate changes, will affect our rate of return and our future pricing to customers."

Suppliers of electricity are particularly concerned with the complexities of cogeneration, which involves "the marketing of our capital investment to serve customers." Other suppliers of energy foresee the increased vulnerability of the U.S. to foreign oil, resulting in legislation intended to spur greater self-sufficiency.

The banking community looks to increased deregulation of their services, calling for "the consideration of nationwide interstate banking" and "increased provision of products and services, i.e. increased powers." Telecommunications companies see the public policy issues in their industry becoming increasingly significant, particularly "equal access of the local telecommunications network and deregulation at the state levels."

Finally, a major airline calls for "the need to continue the process of deregulation to assure our industry is not treated differently or unfairly with respect to other deregulated industries."

Protectionism

Last year's $170 billion trade deficit has some businesses and industries calling for strongly protectionist trade measures. Senate and House leaders, however, know that the bill they shepherd through the legislative process has to be taken seriously by our competitors abroad, while at the same time not forcing the White House into a veto.

There is a strong push from business and industry to retaliate against countries accused of keeping out U.S. exports; for example, Japan's policies regarding U.S. computers and the Common Market's agricultural policies. (In early 1987, the Reagan Administration imposed a $300 million tariff penalty on Japanese semiconductor producers in retaliation for their dumping of such products in Third World nations.)

The debate will continue over the wisdom or folly of trade protection policies. Predictably, the automotive industry and its suppliers were among the firms lobbying most actively for protectionist legislation. Construction-related companies were not far behind:

"Unless the industry obtains significant relief, unfair trade will become more serious as the economy weakens and demand declines."

—a cement manufacturer

Other industries calling for stronger protective measures are metals manufacturers, electronics companies, and textile firms.

There was, however, almost an equal number of respondents that eschewed protectionist legislation. The banking community sees protectionism as "a major threat to the global economy." Retailers claim their "general merchandise companies rely heavily on imports." Two companies see serious flaws in U.S. promotion of exports:

"If the United States did a better job in assuring a positive climate for exports, protectionist pressures would diminish."

—a farm equipment company

"U.S. trade policies continue to give imports an advantage and the 'high dollar,' plus non-tariff restrictions in foreign countries, make it difficult to export U.S. products."

—a food products company

Several companies see the heart of the protectionist issues

in neither the 'high dollar' nor export policy, but in government subsidy of certain industries and exports. Among these comments were:

"One of our product lines is subject to dumping by the European Community into the United States, and is further affected by the European Community's use of huge subsidies."

—a food products company

"The future of the industry and large segments of our company will be impacted greatly by international competition, U.S. trade policies and, more importantly, the policies foreign governments adopt."

—an automobile manufacturer

"We need rules that 'level the playing field' for competition between private, profit-motivated business and state-operated or supported business, which has no requirement to show a profit."

—an airline

A few companies believe they can operate in either climate—free trade or protectionist—as long as they can plan for, and adapt to, change:

"Our company can operate successfully with or without protection from imports. We must, however, base our decisions on existing circumstances or circumstances as we expect them to change."

—a shoe manufacturer

Technology and Economic Competitiveness

The past several years have witnessed the decline of the value of the U.S. share of world trade in manufactured goods. At the same time, the global economic picture has changed as new industries in foreign countries have exported successfully to the United States products that used to be considered distinctly U.S.-made; for example, automobiles, apparel and home appliances. At the same time, U.S. business sees the lead for products based on innovative technologies; for example, semiconductors, also being captured abroad.

Several companies responding to the survey saw the move toward "competitiveness" as requiring a fundamental change in U.S. management values. A major effort to revive the U.S. economy will be needed to affect growing capital formation problems and unresolved budget and trade deficits.

The telecommunications industry expects its competitive position to be constrained by elements of the tax reform bill:

"The investment tax credit has been of great value in encouraging investment in plant facilities. Its elimination is of singular significance to capital-intensive industries, particularly infrastructure industries like telecommunications where improvement in productivity is achieved through technological innovation."

—telephone company

Other comments include:

"We are concerned primarily with the use of technology to enhance productivity, particularly regarding our ability to offer bank services to business via microcomputers."

—a western bank

"Educational improvements are essential if we are to keep pace. We see a short-fall in engineering curricula development and vocational training in secondary schools."

—a structural products company

"Intellectual property matters are a major concern for us. We need patent and trademark rights and protection at both the domestic and international levels. Technology is our greatest competitive advantage and we must move to protect ourselves against theft of our technology by pirates, counterfeiters and others."

—a pharmaceuticals firm

Some firms were concerned with the lack of public education in areas of biotechnology research and innovation. Discussion of genetic engineering of food plants is often fueled by "the public's general fear of anything new in science," writes an executive for a food products company.

Other Significant Issues

Public health concerns are shifting from drug and alcohol abuse to AIDS, and from treatment and disciplinary actions to right-to-know and privacy. Health-care cost containment continues as a concern, despite some abatement in the rate of cost escalation. Benefits to early retirees, threats to the quality of care delivered, access to top new technologies, and the value of corporate wellness programs were cited as continuing interests. Legislation to control health-care costs "affects prices that can be charged for products and services. These must be discontinued if costs can't be reduced. Companies must be able to make a reasonable profit if we are to continue to fund research for new products and technologies," says a health-care products manufacturer.

Federal revenue shortfalls are predicted by many. The new tax bill is not expected to yield the revenues projected from business, and continued federal budget deficits are expected to cause pressure, once again, for increased taxation.

Employment discrimination issues have shifted somewhat. Age and ethnic discrimination issues fell below a recordable percentage in this study, while comparable worth/pay equity issues and discrimination against the handicapped still ranked high.

Banks and financial institutions raised a series of issues critical to their businesses: demographic changes, economic revitalization, small business support, international debt, consumer legislation reform, and interstate bank deregulation.

Interest in South Africa has dropped, reflecting the decision of many companies to withdraw; disinvestment is no longer a question within many companies.

Methods Used to Affect Issues

Respondents were asked to comment on which of the methods available to them are most effective in persuading

key constituent groups to support their views on a particular public policy issue. Public affairs officers were asked to rank and comment on the seven principal methods used below.

(1) Working through trade associations. More than three-fourths of the companies responding identify their trade associations as the most effective tool available to them in affecting the outcome of a public policy debate. This represents a significant shift from 1985, when single-issue lobbying was the primary method for most firms, and only two-thirds of the companies chose trade associations as the most effective mechanism.

"Active participation in our trade association has been very useful to our company. At first, we felt that our association was too large, and the interests of the member firms too diverse, to represent my company adequately. We decided to take a more active role in the association's policy committees, which helped define our position.

"And, of course, the sheer weight of the organization, the number of companies supporting the trade association, has an effect for us in Washington."

—a machine tool manufacturer

(2) Single issue lobbying. This method involves a company and its representatives most intensively. It entails testifying before legislative bodies, writing articles, meeting with interest groups, and, often, hiring specialists to represent the company's interests before state and/or national governments.

"We use lobbyists almost exclusively—perhaps more than we should. If we involved ourselves in an issue in the early stages, we would have less need of professional lobbyists. By the time our senior management takes a serious look at the staff's early identification of the issue, it is too late to do more than add to a trade association's momentum by hiring our own lobbyist.

"In cases where the issue is critical to us, and is finally recognized as such, we go to the best lobbyist we can find. While we have never successfully blocked legislation, we have succeeded in amending bills so that we wind up with something everyone can live with."

—an insurance company

(3) Working with groups of companies. Two-thirds of the companies responding seek coalitions of like-minded companies as a method of affecting a public policy issue. This percentage remains unchanged from 1985 to 1986. Most of these companies do so because there is not an effective trade association available to them, or because there is disagreement among corporate members of an existing association. This was seen most often among manufacturing companies whose regulatory concerns are specific to their industry—or company—alone.

"Our trade association represents so many companies in our industry group that there was no way they could assign the number of people needed to influence the legislation before Congress that concerns recreational boaters and fishermen.

"Coalitions of specific businesses and industries, whose prime market was those consumers directly affected by pending legislation, were particularly effective."

—a recreational vehicles manufacturer

(4) Supporting those candidates who share company views. Almost a third of the companies responding to the survey work with advocacy groups to affect the outcome of an issues debate; this is up slightly from 1985. Firms do so at either the local or national level. At the local level, it seems to be the result of lessons learned:

"Our failures in the past occurred because we were unwilling to become involved in local issues until a confrontation with a public interest group had taken place. We preferred to keep a hands-off policy in local disputes, assuming the adversaries would disperse. As a result, it was often too late for us to gather the community support needed to guarantee a receptive audience for our position. This was particularly true in 'right-to-know' questions.

"Now we involve advocacy and public interest groups as soon as we sense a problem is surfacing. We work *with* them now, not against them."

—a waste management company

(5) Paid advertisements in specialty or general media. Only five percent of the respondents routinely use paid advertisements to influence a decision in the public policy arena. Companies do, however, make use of "institutional" advertising, in which they promote the image of their company rather than try to sell a point of view on a particular issue.

(6) Other means. Fourteen percent of the respondents occasionally use a variety of other methods, often a combination of those described above. This is occasionally augmented by the use of public relations consultants brought in to "polish" the staff work before it is given extensive public airing.

Looking Ahead

When asked to forecast which issues were likely to emerge and become critical to their companies in the next three years, public affairs officers tended to point to a continuing concern with current issues rather than the emergence of new topics. Issues they believe will be of concern through 1990 include:

(1) Tax reform
(2) Environmental issues
(3) Protectionism
(4) Deregulation
(5) Tort liability reform

The response to the same question in 1985 was:

(1) Tax reform

(2) Deregulation
(3) Federal budget deficit
(4) Environmental protection
(5) International trade

Trade protectionism or competitiveness was mentioned often, and trade legislation is expected in 1987. The concerns expressed swung widely between those favoring much tighter import controls and quota legislation, and those favoring more conciliatory solutions.

AIDS and what corporations are able—or ought—to do concerned almost all those polled. The outright costs to business, the privacy rights of victims, the right-to-know of fellow workers, and the profound changes in social and workplace relationships that will occur are likely to concern corporations for years to come.

Between the time this survey was taken and the time this report went to press, the Administration's arms-sale crisis occurred. Conference Board researchers undertook a telephone poll to see if public affairs officers' forecasts had changed as a result of investigations underway.

Before the scandal, respondents had predicted some consensus between the Administration and the 100th Congress. That relationship, some said, would now be characterized by "confrontation." Some respondents foresaw further substantial staff and agency changes in the Administration. Those respondents involved in PACs and, therefore, political campaigns, see the preoccupation with these foreign policy issues continuing through the 1988 election. They cite the lengthy nature of the investigations, comparing them to the inquiry into former vice-presidential candidate Geraldine Ferraro's finances—which took 30 months to complete.